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Looking Forward: Exiting Unconventional Monetary Policy

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I. Introduction

The near collapse of the world financial system triggered by the current financial crisis has led to unprecedented intervention by major central banks, including conventional and unconventional means.[1] Thanks to this massive intervention, accompanied by huge fiscal stimulus packages, including government bailouts, the worst of the crisis has been averted. Most recent data show some signs of stabilization.

As the financial crisis ends, the recession bottoms out, and recovery begins around the world, central banks are under pressure to work out their exit strategy from various forms of unconventional monetary policy, including quantitative easing, credit easing, and in the case of the ECB, enhanced credit support programs. For instance, recently the OECD said: “There needs to be a clear and credible plan and timeline for phasing out the emergency measures as the recovery takes hold. It is critical to consider these exit strategies now in order to prevent new risks in the years ahead.” The reason for such remarks could be the fear of higher inflation. Central banks can not ignore this concern because they can be imbedded into inflation expectations.

In this policy brief, we discuss issues related to exit strategies by central banks. What considerations receive importance when contemplating an exit strategy? What tools are available when the time comes for tightening monetary policy? Do central banks need new tools to implement monetary policy? The message is that, for an exit strategy to work it is not necessary for central banks to sell private sector securities. They can absorb liquidity by selling government securities, as they have done in the past, or paying higher interest rates on reserves. And if a time comes for these assets to be sold, market conditions must return to normal and liquidity restored. Otherwise, the sell off can trigger disruptions in the financial markets.

II. The Financial Crisis and Unconventional Monetary Policy

Under normal circumstances, conventional monetary policy is characterized by the setting of official interest rates. To achieve a certain target for the official rate, open market operations are conducted using government bonds, the most liquid assets in an economy. And when it comes to ensuring financial stability, policy involves no more than liquidity provision to banks, at a given official rate and provided the borrowing banks are solvent. There is no or little coordination with fiscal policy, with monetary policy chosen as the main stabilization tool.

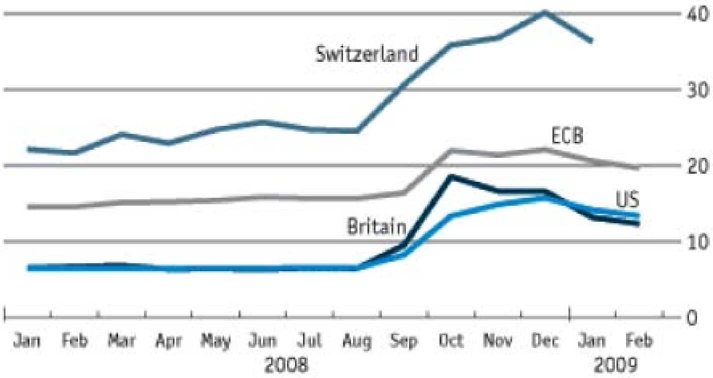
Conventional monetary policy has worked pretty well in the past, and at the start of the current global financial crisis, when central banks around the world intervened to prop up the liquidity position of financial institutions, it was hoped that it would work this time as well. However, as financial conditions deteriorated further and the prospects for a long and deep global recession became apparent central banks were forced to slash their target rates in

[1] See Tesfaselassie (2009).

aggressive moves over the past year. Currently, the US Fed's target hovers between zero and 0.25 percent, down from 5.25 at the beginning of the crisis, and the Bank of England's target is at 0.5 percent, the lowest since it was founded in 1694. The ECB and other central banks have also followed suit.

A major turning point for the conduct of monetary policy occurred when financial markets around the world seized up following the collapse of Lehman Brothers, an investment bank, in September 2008. Faced with the zero lower bound for the official interest rate, central banks resorted to unconventional monetary policy that led to expansion in their balance sheets (see chart). The Fed adopted what its chairman, Ben Bernanke, called **credit easing program**, which involves buying $300 billion of Treasuries, $200 billion in bonds issued by Fannie Mae and Freddie Mac, as well as $1.25 trillion of their mortgage-backed securities. These purchases were meant to drive down long-term interest rates, including mortgage rates. Likewise the Bank of England introduced a **quantitative easing** program of buying up to £175 billion of gilts (government bonds) and corporate bonds to boost the money supply.

Assets of selected central banks, % of GDP



Source: The Economist

The ECB has focused on helping banks. The **enhances credit support** program involved (i) extending the maturity of loan facilities from 6 months to 12 months and (ii) buying € 60 billion of private sector debt, in particular covered bonds (which are backed by mortgages and other loans). The ECB also relaxed collateral requirements by accepting less liquid assets as collateral in its lending programs. The Bank of Japan went even further, implementing programs to support stock market prices.

III. Uncertainty about Economic Outlook and Cautious Approach to Policy Tightening

According to some recent data, the worst of the financial and economic crisis might be over. Consequently some international bodies have revised their short term and medium term forecasts for the world economy. For instance, in its latest Economic Outlook, the OECD has revised up its projections for the OECD area economies. It said, "The slowdown in OECD economies is reaching bottom following the deepest decline for more than 60 years."[2] The good news is that this is the first in two years that OECD projections for growth for the area as a whole have been revised upwards. At the same time, the latest IMF report for the world economy, says that "economic growth during 2009-10 is now projected to be about half a percentage point higher than forecast by the IMF in April, reaching 2.5 per cent in 2010."[3] In addition, market sentiments about future economic prospects are up. For instance, according to Germany's Ifo economic institute, the "Business Climate Index for industry and trade in Germany rose again in July. They are again less skeptical regarding business developments in the coming half year. It seems that the economy is gaining traction."

However, it is too early for central banks to contemplate an exit strategy because the recovery may turn out to be fragile**.** Despite revising its projections, the OECD warns that "recovery is likely to be weak and fragile, and the economic and social damage caused by the crisis will be long-lasting." In fact, while the situation in most emerging markets and the US are improving, "the prospects for the euro area this year have worsened and Japan's have changed little since the OECD's previous projections were published in March."

While the recession is ebbing, labor markets are still weak. For instance, the unemployment rate almost has doubled in the US and some European economies. Moreover, the financial crisis has inflicted huge damage on banks' balance sheets. Their continued deleveraging is accompanied by restrictions on new lending, and thus slowing the pace of business recovery. It will take a while before unemployment rate declines to pre-crisis level, financial markets function properly and banks are well capitalized for them to resume lending to support economic growth**.** As a reflection of these developments, there will be continued downward pressure on inflation over the medium term. Under this sort of circumstance, no central bank would want to exit from its unconventional interventions.

It is also worth mentioning that central banks are still in a vigilant mood because of heightened uncertainty about the future. For instance, as reported by *The Independent* newspaper recently, the Bank of England governor Mervyn King said he was "more uncertain now than ever" over the path of the recovery in the UK. The big question is whether financial market activities are back to normal; that is, to pre-crisis conditions. This is very important as far as the timing of exit is concerned because financial markets are very crucial for the transmission of monetary policy. Finally, there is uncertainty whether potential output has been affected by the financial crisis. This is a challenge even for hard nosed central banks, which focus on price stability. As is well known, what matters for inflation is the level of output relative to potential.

Under theses circumstances, it is very unlikely for central banks to start tightening monetary policy and reversing their unconventional interventions in financial markets. At best, it will take several years before the size and composition of central bank balance sheets return to pre-crisis levels.

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[2] OECD Economic Outlook No. 85, June 2009.

[3] World Economic Outlook Update, July 8, 2009.

IV. The Need for an Exit Srategy

Recently, some central banks, including the Fed and the ECB, have been communicating about the exit strategies from their unconventional programs. It is clear that the articulation of an exit strategy have been forced up on central banks by market participants. The reason is uncertainty regarding the effects of unconventional policy on the economy. Faced with uncertainty, market participants naturally look for guidance about the future path of monetary policy. The concern is driven mainly by uncertainty about future inflation. Such a concern is not unreasonable, given the massive interventions by monetary authorities that led to a sharp rise in their balance sheets. Consider for example the excess reserves of about $800 billion that banks have with the Fed, compared with the typical pre-crisis level of only $10 billion. Whether the inflationary consequences of excess reserves is real or perceived, it should be a matter of great concern to central banks, as inflation expectations could be embedded in long run inflation, making it harder for monetary policy to achieve price stability. Rising inflation expectations are the last thing a credible central banker would like to see.

Thus, even if central banks do not have to start exiting from their unconventional interventions soon, it is important to respond to public concerns by coming up with a credible exit strategy. Exit strategy must be understood as stipulating a roadmap for a tightening of monetary policy when the time is right; in other words, it is about being clear about the end game once the economic environment returns to normal. One must see the strategy as specifying the tools that central banks may use when it is time to tighten monetary policy.

V. Monetary Policy Tools

To foster a common understanding about their exit strategies, central banks need to explain what available tools they have – both conventional as well as unconventional – and how they intend to use them. First and foremost, it should be made clear that when the recovery is solid, financial markets are back to normal and credit risk spreads narrow to a comfortable level and the risk to inflation over the medium term rises, then central banks will start tightening monetary policy. In this case there are no economic constraints in adopting the main tool of conventional monetary policy – open market operations – to push the official target for interest rates (and thus borrowing costs) up. Central banks can engage in outright sales of (or reverse repurchase agreements on) government bonds, the most liquid and safe financial assets.

Open market operations can be augmented by a new tool – raising the interest rate on banks' reserves at the central bank. The benefit of this action would be to make sure that any excess liquidity in the banking system is stashed back at the central bank, thereby preventing excess credit creation and ultimately inflation. In any case, rising interest rates (official and market rates) will be part of any balance sheet reduction by central banks and raising the reserve rate will have effects beyond banks reserves.[4]

[4] This point seems to be ignored in some policy discussions; see for e.g., Hall and Woodward (2009).

Of course, due to uncertain time lags in the effects of monetary policy, the timing of an intervention is very crucial but hard to know in advance because the intervention will represent a turning point in the monetary policy stance. Any signal given by central banks about the timing of an exit strategy would increase yields on long-term bonds via the term structure. The fear is such a preannouncement could drive up interest rates prematurely, derailing the already fragile recovery.

A thornier issue is the unwinding of the asset purchase programs targeted at the private sector. One can not expect the central banks to start selling these assets before the respective financial markets return to normality. Of course, whether central banks will make a profit or suffer a loss when selling private sector assets is unclear. The reason is that, during the crisis, asset prices tumbled partly due to excesses that priced these same assets above their fundamental values and partly due to market panic accompanied by a flight to quality, especially after the collapse of Lehman Brothers in September 2008. If central banks are patient enough to wait until markets return to normality, supporting higher asset prices, they could make profits out of their asset sales. However, the ultimate goal of any intervention should be to support growth and maintain price stability.

In some sense, calls for an exit strategy are reminiscent of the debate on whether central banks should announce projections of future interest rate.[5] Under normal conditions, central bank decisions are based on output gap and inflation projections. Policy stance is captured by the so-called Taylor rule, which proposes how interest rates should respond to inflation and output gap.

The main objection against publishing interest rate projections of central banks comes from the complexity of decision making by committees. Almost all central banks have committees that make monetary policy decisions. Naturally, there is more disagreement among members regarding the future state of inflation and output gap than the current levels. It is not difficult to imagine that the current extraordinary conditions imposed by the financial crisis mean that besides output gap and inflation, assessing normality of financial markets in the future will also play a key role in monetary policy. This creates more challenges for central bank committee members to agree on the future state of the economy and the appropriate course of action. It could, therefore, be counterproductive to dwell into specifics of the exit strategy, in particular the timing of future interventions to be taken by central banks regarding their unconventional policy. The focus should be on remaining alert to the risks posed by inflation and taking appropriate actions when necessary, including rolling back part of the various support programs.

VI. Coordination with Fiscal Policy

It is important that there is scope for coordination of monetary policy with fiscal policy. For one thing, any increase in interest rates means a higher debt servicing burden for the fiscal authorities. Likewise, if central banks start raising the interest rates they pay on banks'

5 See for e.g., Goodhart (2009).

reserves, then reserves will compete with government bonds as investment vehicles. This could drive up government borrowing costs and create tensions with fiscal policy. A possible resolution is to have clearly defined path for fiscal sustainability and let monetary policy focus on fighting inflationary pressures in the economy. This can happen with the full support of governments. They need to understand that the massive fiscal stimulus packages and private sector bailouts can not continue indefinitely. Fiscal authorities should devise their own exit strategies in a way that contributes to the effectiveness of monetary policy in supporting sustainable growth and price stability.

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