Ben Bernanke, the Chairman of the US Federal Reserve (Fed) who has just completed his mandate, belongs to that small group of economists whose curriculum unites both the theory and practice of monetary policy with the utmost degree of excellence and accountability. His track record combines a first-rate international academic degree, specialising in monetary policy and the period of the Great Depression in the 20th century, and acting as the world's foremost central banker, as leader of the Fed throughout what we are already calling the Great Recession of the 21st century.

It is therefore obvious that Bernanke's opinions must be listened to with the utmost attention. At a talk given last January, just a few days before leaving office, he issued an immortal judgement on the two main instruments of unconventional monetary policy employed over the last few years: the quantitative expansion of
the central bank's balance sheet (quantitative easing) and guidance on future interest rates (forward guidance). Bernanke said: «[...] The problem with QE is that it works in practice but it doesn't work in theory [...] and the opposite is probably true of forward guidance». Taking into account who was speaking, it is difficult to think of a more humbling statement for economics, as well as for those who must put economic theory into practice.

So what is the problem with the «unconventional» monetary policy being used by the main western economies? Quantitative easing involves the expansion of central bank balance sheets by buying up large amounts of public and private bonds, with the aim of lowering long-term interest rates, raising asset prices and improving financial conditions for agents. Ultimately the goal is to boost aggregate demand. The evidence indicates that this policy, although not without risk, has been effective to date, reducing long-term market rates by almost one percentage point, especially in the USA. In the presence of rational, informed economic agents without limits to arbitrage between markets, conventional theory argued that this action by the central bank would not be effective since the price of assets would not alter as this only depends on the expected return, adjusted for risk. Naturally such theories are now being revised, most particularly the customary assumptions regarding rationality, the availability of information and the absence of friction. But unfortunately we still know very little about the specific mechanisms through which quantitative easing affects financial and real variables. The risk of causing unwanted effects (on financial stability, for example) calls for prudence, as Bernanke himself has acknowledged.

Forward guidance is a policy that attempts to influence the public's expectations concerning the central bank's official interest rate when this is already very low and therefore has no room to fall any further. Through such a policy, the central bank attempts to commit itself to keeping the interest rate low in the future which, if it is believed by the markets, should help to lower longer-term interest rates and therefore help monetary policy to be even more accommodative in spite of the interest rate already being zero. In practice, this policy's effectiveness is far from proven; it is very recent and still under trial. However, Bernanke's statement should not come as any surprise. It is a policy that works in theory, since a credible
commitment by the central bank can be designed in the models. But in practice this is not so clear. It's much more difficult for a central bank to avoid inconsistencies over time in reality than on paper. In other words, committing itself today to a future policy which might not be the one that interests it the most once the time comes to implement this policy. And the financial markets probably perceive this.

Whatever the case, Bernanke's words reflect a constructive attitude. In practice, monetary policy is supported by the fundamental analytical framework provided by economic theory but always based on the real facts and with a healthy dose of common sense. There is too much at stake to take decisions based solely on theoretical arguments that, by definition, are imperfect approximations of an extremely complex economic world.

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Tags
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