Unconventional monetary policy: an (unfinished) story of (limited) success

The financial and economic crisis that started in 2007 has been the deepest since the Great Depression of the 1930s. At certain points, the nightmare of that social drama being re-enacted looked like coming true. Fortunately that has not happened, largely thanks to how the world's main central banks have handled monetary policy. However, this has not been enough to prevent a phase of slow growth and high unemployment.

Over the last few years, monetary authorities have faced two serious problems. Firstly, the formidable waves of financial turbulence that started with the subprime mortgage crisis. These financial market dysfunctions have upset the normal functioning of the transmission channels for conventional monetary policy, forcing a wide range of «liquidity support measures» to be deployed by the central banks. Secondly, the official interest rate, which is the basic tool of this conventional policy, reached the natural lower limit of 0% without any signs of the worrying recessionary and deflationary dynamics easing. This option running out has led to a search for additional means of stimuli, giving way to «large-scale asset purchases» (LSAPs) and to the reformulation of «communication policies» (forward guidance).[1] The Federal Reserve (Fed) and the European Central Bank (ECB) have played a starring role in this story, both due to the importance of the economies they influence and also to the nature of the measures they have applied.

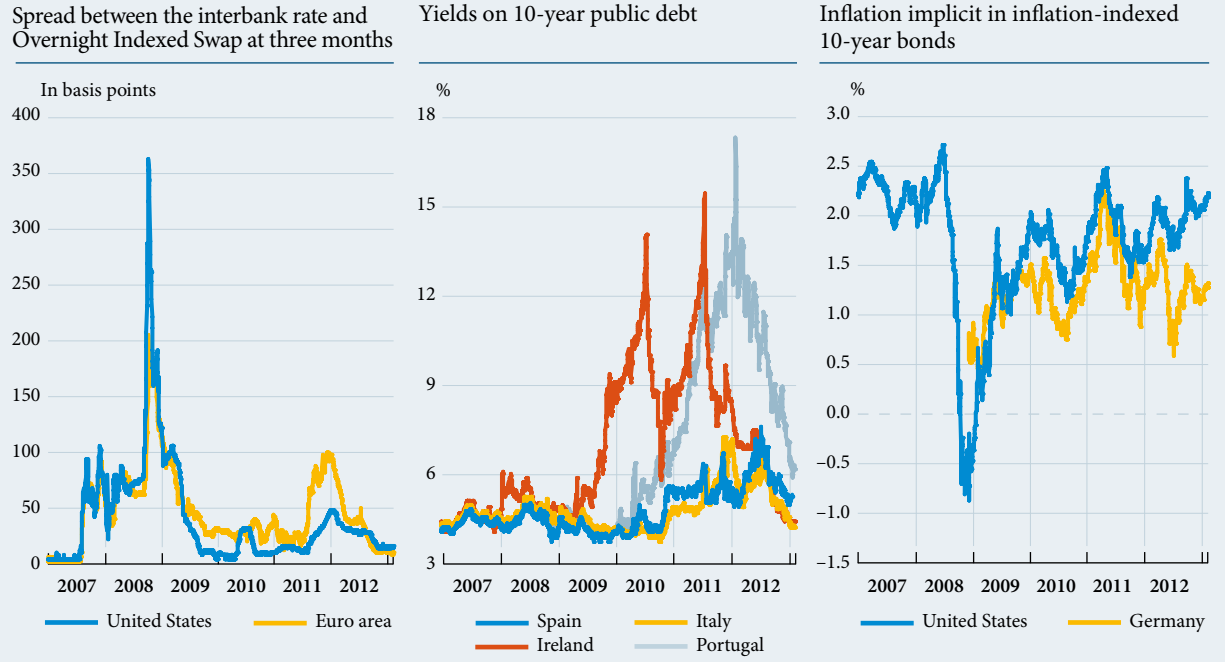
In the first phase of the crisis, between the summer of 2007 and autumn 2008, the Fed and ECB focused on measures to support liquidity at the same time as decisively cutting official interest rates. Their role as lender of last resort was extended to far beyond its conventional scope, reaching unexpected limits after the tremendous shock caused by the Lehman Brothers bankruptcy. The aim was to reopen (or temporarily replace) flows of

(1) For more details, see the box «In times of crisis, monetary creativity» in this issue.

financing in numerous parts of the financial system. The fact that this system is based on capital markets in the case of the United States while that of the euro area is centred on banks is the main reason why the Fed's programmes were aimed at direct intervention in the markets while the BCE's programmes provided banks with liquidity. Extensive empirical evidence has been gathered on the great effectiveness of the many different programmes implemented by the Fed, of a specific and temporary nature. It is worth noting the following: CPFF (focused on the commercial paper market), MMIFF (the money market), PDCF (primary dealers) and TALF (term asset-backed securities). For its part, the ECB also acted with determination and speed: it altered the procedure used to supply banks with liquidity, making this unlimited (the so-called «full allotment»), extending periods and relaxing collateral requirements. These actions avoided the debacle that would have been caused by a chain of banks collapsing, resulting from blocked wholesale markets and/or depositor panic. In fact, calm gradually returned to the markets, a notable achievement considering the aim of ensuring financial stability.

In the period from 2008 to 2009, a second phase of the crisis started that is still with us today, characterized by the need to reactivate economic growth and avoid deflation within a context of falling property prices, forced deleveraging, high uncertainty and recurring outbreaks of instability in financial markets (this time with the epicentre in the euro area). To tackle this challenge, central banks extended their arsenal of unconventional measures. Although the goals were similar, the measures have differed according to the legal and institutional framework of each central bank. The Federal Reserve had very few qualms about embarking on LSAPs and has modified its communication formulas on several occasions, while the ECB has opted for measures halfway between «liquidity support» and LSAPs.

UNCONVENTIONAL MONETARY POLICY HAS BEEN IMPORTANT IN STABILIZING FINANCIAL MARKETS AND PUTTING A STOP TO THE RISK OF DEFLATION



SOURCE: Bloomberg.

The Fed has carried out several rounds of Treasury bond and mortgage-backed security purchases, aimed at pushing up their value and hoping that this upward force is passed on, via different channels, to the prices of other financial assets (corporate bonds, shares, foreign currencies, etc.), thereby helping to ease financial conditions for all economic agents, which in turn should boost the real economy. Empirical evidence shows that these effects have occurred. Specifically, it is estimated that the Fed's intervention has lowered yields on medium and long-term debt by 70 to 150 basis points. Although these estimates are statistically significant, we should remember that there are other factors that have also pushed down yields, such as investor risk aversion, which are very difficult to control when making calculations. These analyses also highlight the fact that positive contagion has occurred regarding other risk assets, principally corporate bonds and stock market indices. Studies analyzing the effect on macroeconomic variables show more discrepancies in the results obtained. On the whole, they detect the existence of a positive but modest impact on GDP and employment, as well as an upward influence on expected and actual inflation. Moreover, it is important to consider that the effect of LSAPs is temporary and that successive rounds have increasingly less impact. In fact, some economists believe their effects do not act so much via asset prices as by modifying agent expectations, and in this respect they are a substitute for communication policy. In this last area, the Fed has received criticism, not totally unfounded, for the erratic formulas it has been trying, sometimes adding to the confusion rather than clarifying the situation.

The ECB has been more prudent than the Fed in this second phase but no less effective for that. Unlike other central banks, the ECB believes that unconventional measures complement interest rate decisions and must be subject to the mandate of price stability. The institution classifies its actions as measures of «enhanced credit support» and justifies them by the need to clear up the transmission channel for monetary policy. However, the emergence of the sovereign debt crisis in the periphery of the euro area almost completely destroyed this transmission as it caused extensive fragmentation of the financial markets between the core and the periphery. The ECB responded with a commendable degree of pragmatism and skill, going beyond liquidity support measures and approaching the terrain of asset purchases. In May 2010, with the creation of the Securities Market Programme (SMP), the first step was taken to contain frictions. In the summer of 2012, this commitment increased with the announcement of the Outright Monetary Transactions (OMT) programme, which has brought about a spectacular fall in risk premia for the sovereign and bank debt of periphery countries.

In summary, the main central banks have demonstrated a capacity to innovate and great determination regarding the challenges that have emerged, achieving satisfactory results. It could be said that they have learned the lessons of some unfortunate historical episodes, when errors of judgement and underestimating the power of the tools at their disposal resulted in tough economic situations. But precisely because of this, we must now be careful[2] to make sure that errors are not committed in the normalization phase, so that the pending epilogue to this story also turns out to be successful.

(2) See the box «Risks of a monetary policy in its experimental phase» in this issue.

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