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Back to Normal: Exiting Unconventional Monetary Policies

From the 1980s through to the financial crisis of 2008, Central Banks focussed on setting a short term benchmark, or policy interest rate, as a way of influencing long term interest rates in an economy. The Central Bank would announce its target for the key benchmark and, if necessary, move in the market to achieve that outcome. The benchmark, or policy rate, anchored other rates which were usually set as a margin or spread above that base.

The policy rate would be moved up or down according to macro-economic objectives which would be specified as part of an institutional framework usually set by government. The objectives could include things such as price stability or full employment. Policy would usually be tightened or loosened in incremental steps. This allowed monetary policy to be calibrated to responses as they occurred in the real economy.

From the 1990s many Central Banks began to target an explicit inflation objective. The policy rate was set with the objective of achieving the Central Bank's objectives over the medium term – perhaps a two or three year horizon. Often the policy rate tracked quite closely Taylor Rule specifications whereby the rate responded to deviations in inflation from target and output from its potential. The policy rate would usually be positive in real terms, that is, it would typically be above current and projected inflation rates. Because this was the system that came into effect after the collapse Bretton Woods fixed exchange rate system and prevailed through to the end of the 20th Century (and a little beyond) most of us came to regard this as "normal" monetary policy.

Unconventional policies

More than six years on from the financial crisis of 2008, policy settings are still very far from that kind of "normal". A whole series of "unconventional" policies have been undertaken. Policy rates have in many cases been taken down to zero and in some cases into negative territory, something that few of us expected back in the days when things were "normal".

For much of the period Taylor Rule formulations pointed to the need to generate materially negative policy rates. Rather than take policy rates well below zero, with the broad range of challenges that entails, Central Banks began to focus on other measures. In several countries this meant greatly expanding the balance sheet of the Central Bank. That balance sheet expansion continues in some areas – a process referred to as quantitative easing, or "QE". Central Banks have bought longer-dated financial instruments in an attempt to shape expectations and put downward pressure on discount rates, thereby encouraging investors to buy riskier assets or to "move out along the risk curve".

QE has often gone hand in hand with credit easing, including the relaxation of collateral standards, meaning that assets on central bank balance sheets are riskier than was the case previously. Central Banks have also paid greater attention to their communications strategies, with "forward guidance" about the future policy stance playing a much more important role in shaping market expectations. This process, begun by the Federal Reserve in the United States, has been also undertaken by the Bank of Japan and now the European Central Bank. Although it has been adopted by all the major developed economies, most of us would still describe it as "unconventional".

These policies have not only eased monetary conditions. One of the consequences, intended or otherwise, is that they have exerted downward pressure on exchange rates.

The current economic outlook

These unconventional policies followed in the wake of the crisis in major financial institutions, and the fallout from that crisis, which commenced in 2008. There was a sharp drop in output in many major developed economies.

The global economy has been gradually recovering since. Even though the degree of policy support has been unprecedented, growth has still been subdued compared with prior experience. Growth has also typically undershot expectations. It has been striking how consistently establishment and consensus macroeconomic forecasts have been downgraded. Invariably, it seems, some "headwind" or combination of headwinds has cropped up to derail expectations. Curiously, the headwinds have been different over time. They have variously included concerns about the "fiscal cliff" in the United States, Euro area stability, the ability of economies to cope with rising rates, inventory cycles, a slowdown in China, disease and even the weather.

Not surprisingly, as time has passed, economists have gradually downgraded their estimates of potential growth in the major developed economies. Outside immediate challenges there are also the longer term structural changes that are coming into play in the developed economies like the slowing in population and workforce growth.

But, it is not only growth that has been subdued. Inflation has consistently surprised on the downside. That seems a far cry from the early days of QE when there was considerable concern in some quarters about the risks of rapidly rising inflation and bond yields. On the contrary, despite the aggressive monetary easing, inflation at the global level has trended down. And more worryingly, some recent measures of inflation expectations, such as market forward implied inflation, have also moved down after having previously remained reasonably well anchored.

The challenges stemming from recent developments, the combination of sluggish growth, lower inflation and extremely accommodative monetary policy have been accompanied by declining long-term interest rates, extending what has been a multi-decade downtrend. Lower rates have provided a boost to asset prices. But that boost comes at the cost of lowering prospective returns - something that adds to the challenges faced by pension funds and insurance companies that seek to provide retirement incomes for ageing populations.

Problems stemming from unconventional policies

The boost to asset prices raises the question of whether asset bubbles are now emerging again. The crisis of 2008 was directly related to an unsustainable build up in housing prices. Banks may now be better capitalized, but the scope for additional policy accommodation in the future is much less given how low policy rates are and how much easing has already occurred. One of the substantive outcomes of the 2008 crisis is the extent to which the Government levered up its own balance sheet in support of deleveraging by the financial sector. Those countries that used public money to underwrite private institutions are now much more exposed than they were seven years ago. In future we may see a distinct lack of political willingness to rescue private sector institutions again, not the least because governments contemplating such action will have much greater fiscal constraints.

Higher asset prices can pose additional problems even in the absence of bubbles. The gains from higher asset prices accrue naturally enough to the owners who are, generally, those better off in a society. This has tended to increase wealth inequality within many countries, something that has become more of a political concern given the muted income gains (and in some cases declines) for all but the highest paid workers. While income inequality at a global level has been declining in many places it has been increasing at the intra-national level.

The income and wealth inequality issues are compounded by the support that low rates provide for the affordability of capital. While capital deepening might ordinarily be expected to boost labour productivity there are few signs that is actually happening or that workers are capturing the benefits. Rather there are risks that low rates make capital cheap relative to labour, with adverse implications for employment.

Low rates also have implications for longer-term growth. When funding costs are abnormally low unproductive businesses can stay in business. That is not only detrimental to those that can make better use of capital, it is also detrimental to longer-term growth prospects. In some instances, where households and governments are seeking to reduce debt, the excessive supply of goods and services will also put downward pressure on prices.

One apparent bright spot is that global imbalances look to have declined. Some of the very large current account deficits that previously existed have all but disappeared. However, this is not all good news. The decline in current account deficits in the "European periphery" countries has come at a very high cost in terms of lost growth and very high unemployment.

Current account deficits naturally contract during deep recessions. What is more important, however, is what the current account deficits might be if countries were to return to full employment. On that score it is not clear that "full employment current account" positions have changed very much. There are also internal imbalances as noted above, with growing income and wealth inequality. The rise in asset prices can also contribute to growing intergenerational imbalances. Baby boomers have been the big beneficiaries of rising asset prices and generous entitlements, while the succeeding generations face affordability challenges, poorer income prospects and much higher per capita levels of Government debt.

Debt, of course features very prominently in this whole story. The global financial crisis was at its heart a credit crisis. The over-indebted private sector and the over-levered business sector scrambled to de-lever. Governments in advanced countries stepped in to mitigate the damaging effects of this process by ensuring that banks were recapitalized and by taking on debt, sometimes to make direct capital injections into banks and in most cases to engage in fiscal stimulus. While policy actions succeeded in stabilizing financial markets and stopping the haemorrhaging associated with the debt-deleveraging process, it is hard to escape the suspicion that the debt loads, or the borrowing from the future that they represent, continue to exert a depressing effect on nominal growth.

We should bear in mind that, despite the apparent ongoing efforts of public and private sector participants to de-lever, overall debt levels continue to increase. The often cited most recent Geneva report, "Deleveraging, What Deleveraging" estimated that global debt levels as a percentage of global GDP have increased by 35 percentage points since 2007. That increase has largely comprised increases in public sector debt in advanced economies and increases in private sector debt in emerging economies.

Putting all that together the picture is of a low growth, low inflation, low rate, and low return/high asset price world with high and increasing levels of debt. The state of the world is quite a distance away from the old "normal". And the response to events to date has reduced the flexibility that will be open to policy makers when they have to deal with future challenges.

Lessons from the old normal

Many observers and commentators will point to the financial crisis and the misdeeds of financial intermediaries as the immediate cause of this state of affairs and note that recoveries from financial crises, particularly ones as widespread as this, do take a considerable time. Looking back, trend growth rates had been declining for some time in the advanced economies, as had nominal and real interest rates. At the same time rising asset prices and strong credit growth had, in the United States in particular, helped households plug the gap between desired expenditure and available income. Global imbalances were marked, but perhaps most visible via the size of current account imbalances. While commentators will point to the contrast between United States current account deficits and China's current account surplus, the biggest imbalances on a relative basis were within the Euro area, with Germany running large current account surpluses and southern European countries such as Spain and Greece running disturbingly high deficits. That might not matter in a single country, but as we all know it matters very much when there is no political, fiscal and banking union.

Most commentators now agree that leading up to the events of 2008 rates were lower than they should have been. There were many reasons advanced to justify the settings at the time. Principally the view was that since monetary policy targeted inflation, in the absence of inflationary pressures there was no need for tightening. Monetary policy was not targeted at asset bubbles. It was targeted at inflation.

Further justification for not raising rates was provided by a succession of shocks – the Asian crisis in 1997, the Russian crisis of 1998 and the LTCM collapse. After policy rates were gradually increased, the "tech wreck" of the early 2000s led to loosening again. The interest rate response to shocks tended to be asymmetric – aggressive cuts on the downside, with less aggressive hikes on the upside.

When real interest rates fall below real growth rates there is a danger that economies move into a state of inter-temporal disequilibrium and dynamic inefficiency. BIS analysis shows that real interest rates in advanced economies did fall below real growth rates for almost the entire period between the second half of the 1990s through to the present. Those low rates effectively brought forward consumption and investment from the future.

As former Bank of England Governor Mervyn King has noted, the future eventually becomes today and then yesterday and even more stimulus is required to bring forward more spending. The net effect is that real yields need to keep going lower and lower to avoid a day of reckoning. And of course in the absence of inflation it becomes more and more difficult to generate lower and lower real yields.

Exiting unconventional monetary policy is a much more delicate matter than entering it.

How do we get back to normal monetary policy from here?

Conventional wisdom is that an economy can move back to normal – or more likely a normal based on somewhat lower potential growth - when financial systems have been repaired, any necessary deleveraging has taken place, output gaps have been closed and growth is at potential with prospective inflation in line with targets. Of course achieving that outcome is more easily said than done.

It would be optimal to use the time that has been bought by accommodative policies to embark on a series of internationally coordinated policy actions that enhance productivity and potential growth so as to maximise the chance for the global economy to grow its way out of current difficulties. Those efforts may well have to be global given that any individual country may find it difficult to normalize if the rest of the world cannot. Efforts to boost infrastructure spending in the advanced countries could be a part of that effort. So would efforts to enhance market mechanisms. Those policies would go hand in hand with coordinated rebalancing efforts and efforts to free up global trade. Those efforts would, over time, see the US and the United Kingdom saving more, China moving to rebalance its economy to one driven less by investment and more by consumption. A Euro area that looked more like a single country would also help. That would entail much greater political, fiscal and banking sector integration. It would also require more practical labour market flexibility. And it would also mean some combination of expansionary fiscal policy in Germany, likely via transfers to deficit countries, a willingness to accept higher inflation, a weaker euro, and wealth losses and sovereignty concessions on the part of the southern countries.

China has been a big part of the success story in the aftermath of the events of 2008. Not only did it manage to continue growth and avoid the excess of financial dislocation experienced by other major economies, its growth was an important part of stabilizing the region and beyond. Of course, China itself realizes it still faces great challenges as it rebalances its economy from investment to consumption and deals with debt vulnerability in its own financial system.

The United States, the first major country to engage in QE, has ended its program of bond purchases. It has gradually tweaked its guidance, transitioning from references to rates being on hold for a "considerable period", to one where the Fed could be "patient" in beginning to normalise rates, to one where the decision on rates is more data dependent. Even though market participants have been led to expect a hike, the first actual hike itself will be very significant. It will be a sign that the Federal Reserve believes that things are getting back to normal, although there will still be uncertainty about the sustainability of rate hikes given previous false starts. Nevertheless, by telegraphing the movement well in advance the Federal Reserve is doing its best to avoid any shock or disorderly fall-out.

In Japan the process of QE is well advanced. There is a realization that it alone will not arrest what has now been a very long downturn. The third arrow of reform, as the Japanese authorities themselves have indicated, is essential to prosperity. And structural reform runs into political constraints which make it a difficult process and in many respects much harder to achieve than monetary policy objectives.

QE in Europe is at a much earlier stage. So far the response has been positive. Of course Europe faces much greater challenges with the Sovereign debt and currency union issues faced by some of its smaller members, with Greece the focus at present.

While QE has been successful in stabilizing these major centres it does have a significant cost as described above. In particular with Central Bank balance sheets stretched much further, those Banks will be more constrained in their flexibility to deal with crises in the future. The solution to the problems of the present has come at quite a heavy cost to the future. And there will be challenges in the future.

Few would believe there have been such significant structural changes as to render future financial crises obsolete or entirely avoidable. There have been significant strides in financial regulation coming out of the work of the Financial Stability Board. But these are responses to the problems of the last decade. The next decade will bring its own problems.

One of the significant effects of QE has been, whether by design or otherwise, to put downward pressure on exchange rates. Obviously not every country can devalue at the same time. The alignment of real effective exchange rates to more historical levels based on economic fundamentals would be another sign that things are beginning to normalize.

The United States Federal Reserve which led the world into unconventional monetary policy will, hopefully, lead the exit in a successful way. It has been careful and patient. We cannot say a successful exit has been accomplished, but we can say it is working in line with forward guidance. It is unlikely that we will ever go back to the “normal” normal. The new normal will not be like that. It will be more subdued. It will be fragile and susceptible to shocks. With less firepower at their disposal policy makers will need to be pro-active in anticipating and managing risk. Preventative action to avoid a crisis is much preferable to the policy response required to respond after the event.