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A FAILURE TO COOPERATE? RAISING THE RISKS AND CHALLENGES OF EXITING UNCONVENTIONAL MONETARY POLICIES

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KEY POINTS

- Central banks (and policy makers more generally) should seek a global consensus before implementing policies that may have global repercussions.
- The global economy can only become more resilient to shocks when there is greater central bank cooperation. The G20 is a natural venue to promote cooperation and to help the global economy return to stronger economic growth, but other forums may also be appropriate.
- The maintenance of financial stability is a common resource and should be treated as such.
- Excessive reliance on sovereignty is counterproductive and contains the seeds of the next crisis.

INTRODUCTION

In an environment where trade and finance are globalized, it is imperative that stabilization policies do not harm the global economy. When the global financial crisis (GFC) erupted in 2008-2009, China was driving global economic growth and emerging markets helped soften the economic downturn. Now, these economies are slowing down, in part, as a consequence of the largest advanced economies, such as the United States, seeking to exit unconventional monetary policies, which now risk becoming entrenched. Policy makers in several emerging markets are becoming vocal about what they see as wrong-headed, inconsiderate policy choices. In this environment, disagreement over the way forward risks stunting hope for global recovery, and the spirit of solidarity

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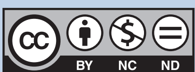

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that marked the early phases of the response to global economy shocks is also being undone, most notably within the G20.

This brief highlights the stakes involved and outlines the choices that policy makers must make to succeed. Perhaps more importantly, the brief shows that it may be more costly for authorities to talk at each other than to act cooperatively. Central banks (and policy makers more generally) should develop a common understanding of the consequences of their actions, and should seek a global consensus before implementing policies that may have global repercussions. This amounts to a sort of Bretton Woods "revival," namely, understanding that policy actions cannot always be defended on purely sovereign grounds; a globalized economy also requires shared understandings about what constitutes best practices. Price stability remains desirable, but central banks will need to prove their dedication to this objective in a flexible and credible manner.

CENTRAL BANKING BEFORE AND AFTER THE GFC

By the late twentieth century, central banks, especially in advanced economies, congratulated themselves on delivering stable and predictable policies believed to be decisive in generating favourable economic outcomes. There was a consensus among central bankers on the best objectives, tools and the institutional framework necessary to deliver macroeconomic stability, which even spread to central banks in emerging market economies. At least informally, central banks effectively appeared to cooperate, though not coordinate, their policies.

Best practice in monetary policy included the maintenance of price stability, possibly using some form of flexible inflation targeting, normally achieved

by manipulating a single instrument, such as an interest rate. Price stability was believed to be necessary for macroeconomic stability and the best contribution in promoting financial stability. Equally important, best practice dictated that central banks should remain independent from political influence, ostensibly to counter the inflation bias of political authorities. Nevertheless, by the end of the first decade of the twenty-first century, even politicians agreed — at least publicly — that low and stable inflation was desirable. The consensus on best practice for central banks was no doubt fuelled by the "Great Moderation" — the decade and a half of relatively stable inflation and growth that began in the early 1990s. In retrospect, the Great Moderation proved illusory, as the Great Recession of 2008-2009 revealed missing ingredients in the consensus on best practice in central banking and monetary policy.

To address the GFC, key central banks in advanced economies quickly lowered their policy rate to levels approaching, or at, the zero lower bound (ZLB). Unable or unwilling to further stimulate the economy, some central banks switched to unconventional tools that considerably expanded their balance sheets, and devoted more effort to communicating their stance through more explicit guidance of market expectations. This included expressing a desire to maintain policy rates at the ZLB for an extended period of time. The major central banks, such as the US Federal Reserve, the Bank of England (BoE), the Bank of Japan (BoJ) and the European Central Bank (ECB), also introduced asset purchase programs expanding the size of their balance sheets, primarily through the acquisition of government securities or effectively backstopping certain forms of private debt. This lowered debt-servicing costs and permitted fiscal authorities to rely on the accommodative monetary policy stance to manage a sustainable debt position by, for example, lengthening the maturity structure of their debt. Once the policy rate ceased to perform its usual signalling function, central banks shifted their policies to influencing other interest rates along the term structure.

Unconventional monetary policy is partially intended as a vehicle for "borrowing time" for much-needed structural reforms, private-sector balance sheet repair and fiscal consolidation, particularly in the economies most impacted by the crisis (Bank for International Settlements [BIS] 2013). Such policies are also intended to boost aggregate demand as a way of easing the economic costs of reform. Economic growth in emerging markets remained strong, while advanced economies entered a sharp slump followed by sluggish growth. None of this is surprising, since much academic research, including the oft-cited Reinhart and Rogoff (2009), explains that recovery is slow in the aftermath of a financial crisis like the GFC. Hence, while the GFC effectively resulted in an unprecedented global loosening of monetary policy, its impact was not evenly distributed.

Accordingly, pre-crisis thinking about the role of monetary policy changed, while the crisis highlighted the importance of a resilient and well-regulated banking system. Emerging markets complained about the negative spillover effects from the prospective withdrawal of ultra-loose monetary policy, while advanced economies countered that some emerging markets failed to use the opportunity to restructure their economies or correct persistent current account imbalances. Central banks in the economies most affected by the crisis also argued that boosting aggregate demand would trickle through the global economy. These developments created tensions between central banks, and the will to cooperate more explicitly

dissipated. By their actions, some central banks revealed what was a largely unspoken rule: domestic priorities come first; international consequences come second. One of the central lessons from the crisis seemed to have been lost: financial crisis in a globalized environment is a shared burden.

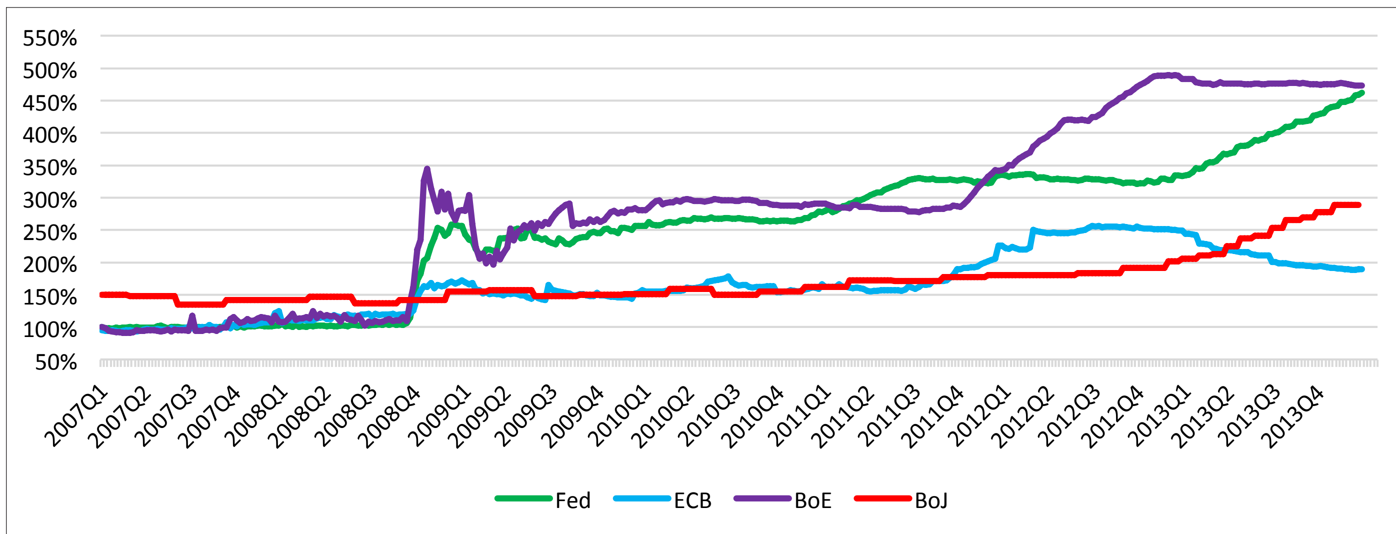
Against this backdrop, withdrawing monetary stimulus too early could halt or even reverse the recovery. Only recently, Fed transcripts from 2008 reveal an explicit acknowledgement that the US central bank was "behind the curve" (see Appelbaum 2014). There is little reason a priori to believe that the exit from ultra-loose monetary policy will be managed any better. Markets were roiled during the summer of 2013 at the mere mention of "tapering." This does not even amount to a tightening of monetary policy, but to a slowing down of the rate at which the Fed provides monetary stimulus to the economy. Combine the difficulties of exiting with a benign neglect of the global consequences of their actions, and the major central banks impacted by the GFC risk creating favourable conditions for a new crisis. The challenge for managing the exit is for central banks to clearly define their objectives and decision-making processes, while acknowledging that their policies have global consequences. The complaints emanating from some large emerging market economies (such as India, Brazil or Indonesia) suggest that there is considerable room for improving central bank communication.

MONETARY POLICY AND THE MEDIUM-TERM OUTLOOK

Central banks' balance sheet activity varies according to the state of their domestic economy and financial markets, their institutional authority and their policy mandate (see Archer and Moser-Boehm 2013). The policies of the BoE, the Fed, and the BoJ are similar, as they have all considerably expanded their balance sheets through large-scale asset purchase programs (see Figure 1). The ECB, meanwhile, has not yet engaged in aggressive quantitative easing (QE). In fact, its asset purchases have only amounted to approximately 20 percent of the asset purchase programs in the United States and the United Kingdom in terms of GDP, and the purchases were sterilized. Of course, the ECB's policies, limited to the provision of liquidity, reflect the limits of its ability to "do whatever it takes" under the lender-of-last-resort restrictions imposed by the Maastricht Treaty. Indeed, the highly successful Outright Monetary Transactions (OMT) policy announced in September 2012 — essentially a bond-buying program with strings attached — remains in legal limbo because the German Constitutional Court suggested that the policy may well exceed the ECB's authority to intervene in financial markets (see Münchau 2014).

As this brief is written, the Fed and BoJ balance sheets continue to be influenced by ongoing asset purchase programs without a predetermined or clearly articulated end date; the BoE's balance sheet is neither expanding nor contracting; and the ECB's has begun to wind down as banks repay funds borrowed through its long-term refinancing operations scheme. While this may reflect improved economic conditions inside the euro zone, the resulting rise in short-term interest rates and the consequence of a return to less liquid money markets threaten future economic growth. The euro-area periphery is particularly vulnerable, because higher interest rates, coupled with the existing risk of deflation, raise the real cost of debt. This also promotes an appreciation of the euro, which has further negative implications for any economic activity that relies heavily on exports. While the ECB is now only a step away from the ZLB and must therefore consider a version of QE, it is limited by the Maastricht Treaty and also boxed in by

FIGURE 1: BALANCE SHEET GROWTH OF THE MAJOR CENTRAL BANKS (2007=100)



Data sources: BoJ, BoE, Federal Reserve, ECB.
The size of the BoJ's balance sheet is indexed to 1999 because it began implementing QE in the early 2000s.

the German court's ruling that its OMT policy may not be legal — at least based on that country's constitutional framework.

The long-term paths for monetary policy appear similar in the United States, the United Kingdom and Japan, while the ECB's policy path is, to date, divergent. In the United States, a relatively stronger recovery has prompted the Fed to begin tapering its current asset purchase program. Although its balance sheet continues to expand at US$65 billion per month, the unwinding process is underway. Both the US and British economies are projected to hit the unemployment target for their conditional commitments to the ZLB in 2014 or early 2015 (see Federal Open Market Committee [FOMC] 2013; BoE 2014); however, as they approach their respective unemployment rate thresholds, there are already signs of dissention about assigning numerical values to an economic state that might trigger exit from ultra-low policy rates, which is eroding the value and credibility of forward guidance. The current expectation is that rates will stay low after the conditional commitment thresholds are reached and that policy rates in these countries will remain at their ZLB for at least two years. Central banks' balance sheets will subsequently begin to wind down, and the monetary policy stance will tighten naturally as expectations concerning future short-term interest rates adjust and longer-term rates rise.

The ECB's current policy stance is not yet as accommodative as that of the other major central banks. The policy rate has not yet hit its effective ZLB, its forward guidance is not as explicit and it is not engaged in any asset purchase programs — although this is partly due to political and legal obstacles. As the policy rate nears the ZLB, it is difficult to see how policy can be made more accommodative without raising the threat of a political and legal backlash. The ECB remains cautious in implementing aggressive policies that would only address short-term symptoms and not the underlying structural problems of the euro area. Sluggish growth and low inflation, as well as fragmented financial markets, are symptomatic of underlying

structural problems and need to be addressed through balance sheet repair, responsible fiscal consolidation and EU governance initiatives. Measures to address these problems are all in progress. The ECB's current policies ensure that there is ample liquidity for money markets, but they also recognize that there are limits to monetary policy and that engaging in unconventional policies may carry more costs than benefits over the medium term.

THE CONSEQUENCES OF STAYING TOO "EASY" FOR TOO LONG

What are the costs of balance sheet policies? Have the major central banks already gone too far? It is widely believed that unconventional policies were effective at preventing the collapse of certain market segments and widespread financial instability, and in stimulating recovery in the real economy (see IMF 2013; Williams 2013). These policies, however, become less effective at the margin while the risks continue to grow.

There are three economic risks and one institutional risk with keeping monetary policy too easy for too long. The first economic risk is market distortions. These could render the use of the policy rate ineffective during the exit process. The second economic risk is renewed financial instability. With negative real yields, investors may become imprudent in the search for yield. Financial institutions might, once again, undertake irresponsible lending practices. A third risk is global spillover effects: exchange rate and capital flow volatility in emerging markets and developing countries can spark financial and macroeconomic instability abroad.

The institutional risk relates to the de facto independence and credibility of the central bank. The more accustomed fiscal authorities and financial institutions become to the accommodative policy stance, the longer they may draw out the process of debt consolidation and balance sheet restructuring. This may lead the government or the financial sector to pressure the central bank to buy them more time by keeping its policy easy for a longer period of time. If monetary policy objectives or the decision-making process become influenced by these actors, central banks essentially lose their de facto independence and their credibility along with it (Hannoun 2012). Central banks can protect themselves by following the adage of former Bundesbank President Karl Blessing, who argued that a "central bank which never fights, which at times of economic tension never raises its voice...will be viewed with mistrust" (quoted in Marsh 1992, 256-7).

Although the potency of these risks varies by country, they are not negligible in the United States, the United Kingdom or Japan. The risk of distorting securities markets is larger for the BoE, the BoJ and the Fed, who hold, respectively, approximately 27 percent, 18 percent and 13 percent of outstanding government securities, while holdings by the ECB are less than five percent. The risk of financial instability from the search for yields and abrupt asset repricing is also higher in the United States, the United Kingdom and Japan because their government yields are at an all-time low, and equity and corporate bond prices could begin to bubble if easy monetary policy encourages a higher risk appetite (Rawdanowicz, Bouis and Watanabe 2013).

The risk of financial instability is even stronger in the United Kingdom because it also faces a potential housing bubble. The monetary policy bodies at the Fed and the BoE are monitoring the potential buildup of financial risks through the search for yield or imprudent lending practices. Those at the Fed generally view these risks as moderate, but they continue to play a key role in the

short-term monetary policy decision-making process. Those at the BoE believe that monetary policy does not pose a threat to financial stability that the macro- and microprudential supervisors and regulators could not contain. This story has been heard before. So long as the effectiveness of macroprudential regulations remains in question, we should remain hopeful but skeptical. In Canada, for example, the impact of the Ministry of Finance tightening mortgage lending rules is undercut by the Bank of Canada's (BoC's) low policy rate for the foreseeable future. The BoC believes that its policies, which include a form of moral suasion intended to temper banks' ability to freely lend credit, work well in tandem with the ministry's stand. However, internationally, policy rates close to the ZLB also encourage a search for yields, and consequently, heighten the incentive for risk-taking by investors, both domestic and foreign. While there may not be a property bubble in Canada, the fact that, in the aftermath of the crisis, private debt to GDP is higher than in the United States lends ammunition to critics of the macroprudential solution.

International markets are particularly sensitive to the Fed's monetary policy because of the dominance of US treasury securities in global markets. Recent tapering by the Fed has created an outflow of funds from emerging markets, particularly in Brazil, India, Indonesia, Turkey and South Africa, weakening currencies that are needed to fund foreign denominated debt.[1] In response, central banks in these countries have been tightening monetary policy, but this depresses economic activity. The Fed's current attitude toward the international effects of its monetary policy appears to be that it will communicate the expected path of its policies so that emerging markets can manage their economies using domestic macroeconomic policies while the United States oversees its own. Chair of the Federal Reserve Board of Governors Janet Yellen (2014) solidified this view during her testimony to US Congress, stating: "We have been watching closely the recent volatility in global financial markets. Our sense is that at this stage these developments do not pose a substantial risk to the U.S. economic outlook." Outside the United States, views are different. Even if the feedback loop into the United States is negligible, this seems to assume that emerging markets will adopt the correct policies, but it is hard to imagine that a slump in BRICS countries would not reverberate back. Taken at face value, reactions such as these ought to increase the challenge of coordinating monetary policies around the globe. Nevertheless, effective communication is not a science, and the Fed's previous failed attempt to signal the coming tapering in May 2013 suggests that pleas by some central bankers for more cooperation should not be ignored.

WHERE DO WE GO FROM HERE?

Central banks are beginning to face the difficult challenge of managing the risks associated with exiting extraordinarily accommodative policy stances. Transitioning away from the price stability objective toward a "new normal," which includes a financial stability function, requires a shared coordinating mechanism across domestic and international institutions. Too much concern over the risks to financial stability might lead central banks to pre-emptively withdraw stimulus, which risks halting or even reversing the recovery. Governmental, financial and international authorities might pressure central banks to maintain lower policies longer to buy time to consolidate debt, restructure balance sheets and

1 On a positive note, recent events may well reinforce emerging markets' desire to issue debt in their own currencies. Whether investors will be encouraged to take up this kind of debt is another matter beyond the scope of this brief.

implement much-needed structural reforms, but unfortunately, the resulting delay raises the risks of moral hazard, leading policy makers to put off the inevitable, with potentially larger economic consequences.

The BIS has stressed that there are limits to monetary policy and that it cannot borrow time forever. Policy makers must address the effects of the monetary policy stance on the government's fiscal position, balance sheets in the private sector and in international markets. Coordination among domestic policy authorities is necessary for delivering stable macroeconomic and financial conditions, but coordinated efforts to secure a sustainable recovery cannot rely on monetary policy and should not infringe on central bank autonomy. By virtue of central bank intervention along the term structure, especially in influencing long-term interest rates, the domestic element in achieving a successful exit has taken on even more importance in the aftermath of the GFC (Turner 2011).

Perhaps more importantly, policy makers and central banks risk misreading the implications of spillover effects as each economy puts its house in order. International policy cooperation was relatively straightforward at the height of the GFC when stimulative domestic macroeconomic policies were necessary for stabilizing domestic and global demand and financial markets. At the time, domestic monetary and fiscal policies reinforced each other and consequently, there was no conflict. But international cooperation, let alone coordination, has become more complicated because economies require different levels of stimulus. The best policies for many advanced economies, especially the United States, might not produce net benefits for the rest of the world as was once assumed (see Bernanke 2012).

The global economy can only become more resilient to shocks when there is greater collaboration among central banks. The G20 is a natural venue to promote cooperation and to help the global economy return to stronger economic growth. The best contribution that political leaders can make is to convince the public that monetary authorities must remain the autonomous guardians of price stability and central to managing financial stability. The G20 should underscore the need for central bank consultation, but it may be seen as too political an organization for spurring genuine conversations among central bankers; the BIS might be a more appropriate forum for such conversations. These are already taking place — albeit outside in a non-transparent fashion. The current bimonthly meeting of central bank governors at the BIS should not be replaced; rather, there may be a way to use these informal discussions as a springboard to communicating to the G20 and the public that cooperative solutions are being sought.

RECOMMENDATIONS

Central banks were the front-runners stabilizing the economy and financial system, and promoting growth throughout the GFC. The major central banks that engaged in aggressive, unconventional monetary policies are facing pressure to unwind and withdraw stimulus in the coming year or two, and it is clear that their monetary policies will have global implications. Securing a stable global economic recovery will require clear and credible communication and carefully designed policies during the exit. A state may be reached when, as central bankers have stated repeatedly, monetary policy can no longer stimulate the economy, but only perpetuate and encourage existing global economic imbalances. The following

recommendations would help stabilize a transition away from unconventional monetary policies and shift the burden toward other stabilization policies that are in need of repair:

- G20 leaders should encourage central banks to come to a shared understanding about transitioning to more conventional monetary policies. While coordination among central banks is unlikely, given their domestic mandates and competing policy interests during the exit, cooperation would likely improve economic and financial stability.
- Concerns over the loss of central bank independence are misplaced. The best way for central banks to remain autonomous is to show that monetary and fiscal policy can act in harmony.
- The channels through which domestic monetary policy affects international actors and the global economy are not well understood. More research on the transmission mechanisms of international spillover effects ought to be promoted, identifying the differences between emerging market and advanced economies.
- The importance of central banks and the relative stability of inflation throughout the GFC underscore the fact that the benefits gained through price stability should not be abandoned. While the crisis has revealed that there is a role for central banks in financial stability, their basic monetary policy strategies remain sound and will provide a necessary source of stability during the recovery. The focus should be on a clearer definition of the financial stability concept and an acknowledgement that managing differing objectives might require institutions to stop hiding behind the politically convenient protection of sovereignty when developing and implementing policies.

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