REASSESSING CONVENTIONAL AND UNCONVENTIONAL MONETARY POLICIES

Alina Georgeta & Ailincă[1]

Abstract: A lot has been written about the conventional and unconventional monetary policies, and the literature shows the advantages and disadvantages if these monetary policies. It can often be noticed that there is no clear, unanimously accepted explanation for giving up the conventional monetary policies; only their limitations are showed. It is also not clear how much or which of the quantitative easing, negative policies rates or forward guidance policies were beneficial for the economic growth, production and inflation. There is an opinion that their use cannot be beneficial on the long term because they are mostly circumstantial measures, but their withdrawal might also be difficult and, if done, it should be gradual. The paper aims to provide a critique of the conventional and unconventional monetary policies, examining thoroughly their role and behaviour within the real and monetary economy. The paper shows that the mistrust and the lack of correct and complete assumption of the role of the monetary policy within the economy are among the causes of the limitations of the conventional and unconventional policies within the economy.

Keywords: monetary policies, quantitative easing, policies negative interest rates, forward guidance

JEL Classification: E40, E52, E58, E61

1. Introduction

Within the context of the global economic and financial crisis, the main central banks of the world adopted measures to improve the world monetary, financial and economic conditions. These measures went beyond the classical context of influencing the short-term interest rates, entering the so-called sphere of the unconventional.

Generally, the monetary policy acts on the economy and inflation control through more or less conventional instruments. The stimulation of economy and, sometimes, even the impulsion of inflation, can be done by reducing the monetary policy interest rate. This influences indirectly the economy by, for instance, decreasing the interest rates for the mortgages and car loans and by consolidating the stock exchanges by increasing the volume of transactions and by increasing the trust in the economy. This improves the financial conditions and enhances the trust of the households and companies in spending, producing and selling as much goods and services as possible. Inversely, when the economy overheats, the key interest rate is increased to temper the economy and the inflation. This reality is valid, however, up to a specific level, the monetary policy interest rate being unable to adjust the economy further in the proximity of zero, the negative interest rate being equivalent with a penalty for the deposit holders. Nevertheless, invoking the limits of the classical monetary policy, the use on unconventional instruments was seen as the “saving” solution by many specialists and by the managers of the main central banks worldwide, being able to direct the world economies on the road of stability and, even, economic growth.

2. Literature overview

The literature on the impact of the unconventional monetary policies is considerable, with arguments in favour of the fact that they helped reducing the lack of liquidity on the financial markets and the stress on the financial and monetary markets, while relaxing the general conditions for credits.

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[1] Scientific researcher 3rd degree, “Victor Slăvescu” Centre for Financial and Monetary Research, Bucharest, The House of Romanian Academy, Calea 13 Septembrie no. 13, Romania, Telephone: +40.21.318.24.19, FAX: +40.21.318.24.19, e-mail: icfm01@icfm.ro; corresponding author email address: alina.glod@gmail.com.

According to Borio & Zabai (2016), although they were supposed to be temporary and exceptional, the unconventional monetary policies turned out to be rather permanent and standard, their limits expanding. The distinction between the lender of last resort and usual operations became extremely blurred (Domanski et al, 2014), both during the period of prolonged „crisis” and during the period of normality or, even, stability.

3. Methodology

The paper aims to make a constructive critique and the debate the positive and negative elements of the conventional and unconventional policies of monetary policy. Making comparisons allows understanding more the pluses and minuses of the unconventional methods. The monetary policies are classified as conventional or unconventional, but they actually contain a mix of conventional and unconventional measures or instruments. Even the conventional elements are often pushed into the unconventional area, making the conventional instruments lose credibility. Practically, the set of instruments at the international level and, particularly, of the central banks is rather mixed, the trait of “conventional” or “unconventional” being due to the preponderance of these measures and to the assumption of a particular role within the economy. The paper is a partial and updated valorisation of the 2016 theme with the title of „Post- crisis monetary policy - trends, instruments, objectives” (main coordinator Ailincă, A.G.) of the Centre for Financial and Monetary Research „Victor Slăvescu”.

4. Arguments in favour and against the conventional monetary policies

The monetary policy acts indirectly on the economy, and initially directly only on the interbank monetary market, by setting targets for the overnight interest rate for the credit and deposit facilities and through open market operations for the supply or withdrawal of liquidity. Central bank operations are, in principle, reversible, managing the conditions of liquidity on the monetary markets and the long-term price stability. Irrespective of the nominal anchor, especially in the small and open economies which use inflation targeting as anchor, the central banks use open market currency operations to dampen the exchange rate shocks (Stone et al, 2009). According to Bini Smaghi (2009): „in normal times, the central bank is neither involved in the direct crediting of the private sector or of the government, or in direct purchases of state bonds, of corporate debts or of other type of debt instruments. By directing the interest rates level, the central bank manages efficiently the liquidity conditions on the monetary markets and follows the main objective of maintaining the medium-term price stability”. When the monetary policy interest rate goes beyond zero level, unconventional measures of monetary policy are to be enforced. According to Alexander et al. (1996), the most used direct (conventional) instruments are interest rates control, direct crediting and credit ceiling; among the indirect (unconventional) instruments are the open market operations, credit facilities of the central bank and the minimal compulsory reserves. In order to maintain the financial stability, the central banks use the lender of last resort mechanism as conventional instrument to provide liquidity for the credit institutions.

Since the conventional monetary policy has been used for many decades, the effects which it might have and must have are known, but the effects of the unconventional monetary policies are not fully known and the extent of their effects are yet to be fully ascertained (Williams, 2012).

On the other hand, the use of unconventional monetary policy methods seems to be motivated by the incapacity of the central bank to meet its objectives either because of a dysfunctional mechanism of transmission, or because the further reduction of the interest rates can’t guide the expectations regarding the long-term interest rates and can’t improve the financing conditions on the interbank markets.

According to Bernanke, Reinhart and Sack (2004) and to Bernanke and Reinhart (2004), when the nominal interest rate reaches zero lower bound (ZLB), and the evolution of prices is downwards, the monetary policy efficacy depends on the policies or on the alternative measures such as: 1. Use of communication policies to model the public expectations on then future interest rates evolution; 2. Increase the central bank account balance; 3. Change the central bank balance composition. The authors note that although for the USA, the results of using non-standard instruments are better than for Japan (at least regarding the efficiency of the communication policies), prudence must be maintained in evaluating the results, since they are rather unsure in terms of quality. The authors also suggest that the actions of the monetary policy managers should be directed towards the prevention and control of deflationist risks (idea previously supported by Reifschneider and Williams, 2000).

5 .Arguments in favour and against the unconventional monetary policies

According to the IMF (2013), in order to restore market functionality and the financial intermediation the main central banks, such as Great Britain central bank, the Fed, ECB and the Bank of Japan, used unconventional monetary policies. This shift to an "unconventional" approach also had another argument, accommodate the interest rate evolution at Zero lower bound. The purpose of implementing these unconventional measures was to ensure the macroeconomic stability. In order to restore market functionality and the financial intermediation, according to the IMF, the banks used private asset purchases and targeted liquidity provision, while to accommodate the interest rate evolution at Zero lower bound, they used bond purchases and forward guidance. These measures proved somehow their efficiency during the peak period of the crisis, when the risks were lowered, market functionality was restored, the international trade returned to normal, the credit spreads decreased and the yield of the long-terms securities decreased.

However, despite some beneficial effects of the short term, as the, already high, flows of capital of the world central banks become excessive, there is the possibility of future macroeconomic constraints and of return to the period of crisis. The macroprudential policies can solve some of the problems but, within the context in which the real, financial and public sectors are not reorganised, the pressure on the monetary policies increases more and more. This "more and more" might highlight a moment of crisis or a turning point in the role of the monetary policies within the economy and society in general, or in the manner of applying these policies in practice.

The main objections regarding the unconventional monetary policy measures regard the practical aspects of their implementation, the correlation with the traditional measures and the coordination with other macroeconomic policies.

There is no unanimously accepted definition of what is or isn't conventional in the matter of monetary policy, and the limit between them often disappears. Under the present conditions, the limit between the monetary policy and the fiscal policy also is hard to notice (Roubini, 2016). However, when the monetary policy interest rates are brought to zero or in its proximity, and there is the danger of deflation, which sometimes even occurs, unconventional monetary policies are often called in to ensure the liquidity and depth of the financial market (IMF, 2013). According to Caruna (2009), the unconventional monetary policies are defined as operations of administration and increase of the liquidity, passing from a passive role – ensuring the objective of a particular interest rate level under normal conditions, to an active role – influencing the general financial conditions of the market. He sees the unconventional monetary policies as an instrument of crisis management, which completes and expands the classical monetary policy.

According to Bini Smaghi (2009), when the monetary policy interest rates are brought to zero, or when they don't function efficiently even above this level, they can be compensated by additional measures such as forward policy guidance; increasing the size of the central bank balance; change the composition of the central bank balance. Therefore, these unconventional measures aim to improve the financing conditions by increasing the liquidities, by adjusting the interest rate margins for credits and of the maturities on different segments of the monetary market and by restoring the trust. At the same time, he notices that if the quantitative easing (QE) measure, which aims to change the market conditions for the riskless assets, such as the governmental bonds, is prevailing, then the monetary policy interest rate is zero or in its proximity, while the credit easing, directed towards changing the market conditions for the financial assets irrespective of the risk, may also function when the nominal interest rate is positive. Both measures bear upon, however, the size of the central bank balance and may increase the exposure of the monetary authorities to risks.

In the USA, after the 2008 moment, according to Williams (2012), the Fed used forward policy guidance and large-scale asset purchases or quantitative easing.

Forward policy guidance is that instrument which guides the future decisions of the households, investors and businessmen suggesting the direction of the short-term and even medium and long-term interest rates, as well as market conditions and expectations. Its efficiency has been proved for the USA, particularly after 2011, showing Fed's intention to maintain low short-term interest rates much after the economy recovers. There is, however, the risk that under the possible inflation pressure, the central banks that use this instrument will no longer be able to use it as they promised, for instance by increasing faster the key interest rates (Walsh, 2009). The public expectations can also differ from central bank expectations, and this is why forward policy guidance may not work properly (Williams, 2006), given the important differences between what the central bank wants and what the public wants.

Large-scale asset purchases or the quantitative easing (Q.E.) or balance sheet policies – this instrument works very well with fragmented financial markets, with investors whose preferences are properly shaped, in which the demand and offer of financial assets influence their price. For instance, if a central bank purchases large amounts of treasury bonds or securities having mortgages as collaterals, then the offer of these securities towards the public decreases, their price increases and their yields decrease; as the effect is contagious, the rates of other medium and long-term indebting instruments also decrease, which stimulates the economic activity of the companies and household consumption. At the same time, the unconventional monetary policy influences the yields and price of the state bonds both before and after announcing such measures of monetary policy. To the extent to which the quantitative easing also captures the decision-making aspect of the central banks to relax the monetary conditions in the future, one may say that this also supports the forward guidance measures, practically being complementary measures (Williams, 2012).

According to Woodford (2012), the forward policy guidance measure proved to be efficient by decreasing the expectations for the future interest rates, while according to Swanson (2011), Chung et al. (2012) and Chen, Curdia, and Ferrero (2012) QE measures have important effects (often with magnitude similar to that of the forward policy guidance and of decreasing to 1pp the interest rate to federal funds in the USA) on the yields of the long-term (10 years) treasury bonds.

According to Cerna (2016), by adopting in early 2015 a quantitative easing-type policy, the European Central Bank managed to stimulate the demand on the background of intensifying inflationist anticipations and decreasing interest rates in the euro zone countries, and to depreciate the European currency in relation to the main world currencies, which stimulated the exports of the euro zone countries. At the same time, this expanded the process of financial assets portfolio relocation towards higher risk and higher yields placements, which increased the price of the euro zone company shares.

There are studies showing that the unconventional monetary policies have a positive, refreshing impact on the economy, thereby increasing the GDP, decreasing the unemployment rate, preventing the possible deflationist effects and improving the financial conditions on the capital markets. For instance, according to Chung et al. (2012), the quantitative easing program QE2 in the USA (as of November 2010), amounting to US$ 600 billion, decreased by about 0.3 pp the unemployment rate compared to the variant without this program, increased the GDP with little more than half percent point and increased inflation by 0.2 pp. the same authors estimate that the joint effect of the QE1 and QE2 programs from the USA, decreased the unemployment rate by 1½ percent points and shielded the US economy from the danger of deflation. Another effect of the unconventional measures, particularly of the quantitative easing, is the devaluation of the national currency against other currencies. For instance, according to Neely (2011), QE2 program depreciated the US dollar by about 3-4%, which increased the competitiveness of the US production of goods on the domestic and foreign markets. It is, nevertheless, difficult to determine for sure how much of these effects is due to the unconventional monetary policies, and how much to other factors.

Furthermore, despite ample unconventional monetary policies (see the Bank of Japan, in the early 1990s) inflation remained low, but there is the danger of future inflationist pressures. A possible explanation why the quantitative easing could not drive sufficiently the inflation and the economic growth is the fact that it operates mainly with the nominal economy, not with the real one, which is why it doesn't stimulate the purchase of goods and services, its beneficiary being mainly the financial-banking system. The brutal withdrawal of the quantitative easing measures may lead to losses of capital and financial instability, including losses in the balance sheets of the central banks.

The unconventional monetary policies can contribute to the acceptance of excessive risks on the international and regional financial markets, on the background of the continuous need for high yields on the markets with flattened average yields. Speculative bubbles are likely to appear again, even on the real estate market, which was the cause of the recent global crisis. Using quantitative easing, states and areas such as the USA, Great Britain, the euro zone and Japan, influenced the consumption and investment decisions, the production, purchase and sales decisions, altering the economic decisions regarding financing, forcing the inefficient functioning of the economies, decreasing the impulse that would make the states improve their finances and make the necessary economic reforms, often decreasing the possibilities of future investments, outflows of capital directed towards the emergent economies. Some of them already have problems with the overvaluation of the exchange rate and might have to increase the interest rates so as to reduce the excess of liquidity. Furthermore, according to Cerna (2016), on the background of the QE, the stronger legislative constraints, the prudence manifested by the financial institutions, the excess liquidity supplied by the ECB on particular segments of the financial market, as well as the low interest rates, might make some financial-banking institutions get less involved in the role of market maker.

The low monetary policy interest rates are somehow connected to the persistent expectations regarding a low level of inflation, but the improvement of work productivity and the revival of the economic cycle might cause the regime to change. The analysts often wonder whether the inflationist expectations can be raised by increasing the monetary policy interest rates (vision shared by the Bank of International Settlements and by

Blanchard, 2013, Williams, 2016 etc.), with the purpose of avoiding the possible speculative bubbles. Nevertheless, if this change of regime is not interpreted as credible by the international markets, besides the maintenance of inflationist pressures, new financial recessions and crises might by generated.

The massive inflows of capital can deregulate both the external balance and in internal balance of investment-saving and might start possible speculative bubbles, and the production might exceed its potential level, as it was noticed in South-Eastern countries of the EU before the crisis. This can also be started by the measures of quantitative easing used by the main central banks of the world, which pushed the financial liquidities, in their pursuit of better yields, towards the emergent economies. Therefore, the monetary policies of the main central banks of the world should find solution to increase the potential GDP and to boost the economic growth in general; the role of the monetary policy should be the search for a better connexion with the other macroeconomic policies (the fiscal-budgetary policy, in particular) regarding problems pertaining to investments, innovation, education, research, health, demography etc. Higher interest rates used by the main world central banks under these circumstances is not the solution, rather the change of paradigm by the contribution of the monetary policy to the improvement of the general framework or of the general structure of the world economy and of each individual economy of the world. The central banks may influence positively the world economies by increasing the level of decision-making transparency, bringing into light the obscure banking system, under sizing or adapting the dimension of the financial system to the needs of the real economy, capital markets reform and disciplining, discarding the incorrect practices both by regulations and by increasing the level of financial education, removal of as many as possible negative externalities of the banking system in the real economy.

In the discussion about the unconventional methods wed might also include the controversy between the Helicopter Money and the Fiscal Money or Tax Discount Bonds – TBDs. The Fiscal Money is issued by the state ad guaranteed with future revenues from taxes and dues, while the HM are issued by the central bank and should go directly into the possession of the population. Another alternative is a new form of quantitative easing for the people, QEP, idea which also contains money issuing to finance the public investments and state banks, thus increasing the state control over the economy. According to Grazzini (2016), it is preferable to issue FM (or TBDs) because, in his opinion, the public debt doesn't increase (this money is not registered as state debt according the Eurostat criteria), the bonds being issued free of charge for their holders (resembling thus to the HM) on a period of 2 or 3 years with negotiation on the financial markets; they can readily be converted into cash, being allocated to the households inversely proportional with their income, and to the companies proportional with the number of staff, supporting thus their competitiveness and decreasing the cost of labour. The state might also use HM to increase employment, to increase the investments and to pay the wages of the employees paid from the state budgets. Another argument, in the opinion of Grazzini (2016), in favour of the FM, is the fact that Germany, through its public authorities, will never agree the HM, and the ECB will never be able to issue this money. Furthermore, while not breaching of EMU regulations, the national governments can issue FM without increasing the public deficit and without increasing the role of the state within the economy (only a very low share might go to the state).

6. Conclusion

The unconventional monetary policies, implemented some 10 years ago, turned extremely classical and common, their effects being often controversial, particularly on the medium and long-term. Sometimes unpredictable, other times even dangerous and with confusing effects, the unconventional monetary policies may raise questions regarding the legitimacy, credibility and force of some central banks to manage monetary problems of market stability and economic stability.

The role of the monetary policy within the economy should be understood and highlighted, as well as its limits and manner in which it can join effect with the fiscal policy. The incomplete, even incorrect, use of the monetary policy because of the misunderstanding of its role may be bad not just for that particular monetary policy, but also for other world monetary policies, and for other economic and politic realities in that region, or worldwide. Furthermore, the monetary policy, exceeding its area of competence, of the treated in a purely monetary manner, causes of other nature (such as conjectural, structural, fiscal, social, socio-cultural, geopolitical, etc.) of inflation and financial stability.

By the injection of money into the economy, these methods seem rather "constrained" in the idea of stimulating at any price the general offer, the economic growth, inflation and the exit from the liquidity trap. The excessive stimulation of the economy forces market limits and even the conventional behaviour of the population and companies. Thus, many of these instruments could not serve to increasing consumption, rather to increase saving (particularly as deposits), and the population might purchase more imported goods and services than domestic ones, thus stimulating the foreign production of goods and services. Furthermore, a major cause of the limited functionality of the unconventional measures may be the pre-crisis indebting and over-indebting, and even during the crisis. More precisely, the additional liquidities intended for consumption and to boost the aggregate demand, as seen by the central banks, might be actually money to pay the past debts and liabilities, this aspect might even be a positive one, if past liabilities and settled, and if the personal or company financial state is reset, only if these categories will not make a modus vivendi from the excessive indebting. Therefore, pumping money may, in the best case, find positive effects in the economy after a rather long period, more than initially anticipated by the central banks, period in which new monetary and/or non-monetary shocks may appear. This would further complicate the realities which the central banks of the world will have to tackle.

The dispute between benefits and costs, between the arguments in favour and against the unconventional monetary policy methods is not an easy one; there are, however, clues that show that the present direction will have to be reversed, some time (which the Fed has already done), in order to create a normal space of manoeuvre for the monetary policies and to allow the proper management of the adverse effects of the possible future crises.

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