Unconventional Monetary Policy: Moving Toward the Exit in the U.S.

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Industrial countries and currency areas have had to rely on extraordinary monetary policy accommodation to encourage economic recovery following the financial crisis of 2008 and the problems in the eurozone and elsewhere. Private sector demand has been slow to bounce back, even at unusually low interest rates. This is in part because households entered the recession with too much debt and too many real assets—houses, autos, other consumer durables—that have been worked off gradually and only by sharp cutbacks in borrowing and spending. And businesses have been reluctant to add to capital when demand has been so sluggish. Because intermediaries and other lenders have had to adjust to greater borrower problems, uncertainty about collateral values, and questions about their own credit worthiness, access to and cost of credit for many borrowers did not improve as much as indicated by the decline in benchmark interest rates as monetary policy eased.

The pressure on monetary policy to support the recovery has been intensified by fiscal consolidation in many industrialized countries. The ability of fiscal policy to boost demand has been hamstrung by concerns about debt sustainability in industrial countries, especially in the face of prospective spending increases to meet the needs of aging populations. In the eurozone, pressures on government debt levels have been exacerbated by the perceived need to support banking systems as property bubbles burst and economies on the periphery went into deep recession. The result has been fiscal policies in the U.S. and elsewhere that have weighed on economic growth through tax increases and spending cuts, requiring much easier monetary policies than if fiscal policy had been less pro-cyclical. Demand has been stronger in the emerging market economies (EMEs), but not strong enough to fill the hole in global demand left by the retrenchment in industrial countries.

Weak demand also has been associated with inflation coming in below target in many industrial countries. Nominal interest rates were already at moderate levels when the various problems hit and central banks soon found themselves with their conventional policy instrument at zero, so they had to employ unconventional measures to ease financial conditions further in order to boost demand and raise inflation to target. Two types of unconventional policies have been used: portfolio expansion through asset purchases or increased lending, and guidance on how long or under what circumstances the short-term rate would be kept at zero, thereby reducing rate expectations and longer-term interest rates.

The U.S. has seen some signs of a revival in private demand, although the overall pace of expansion remains quite damped owing to fiscal consolidation. Debt levels have slowly been brought down through restraint on consumption and borrowing and by default on some debt. Overhangs of houses and consumer durables have been worked off by extremely low levels of production relative to population growth and trends in household formation. And credit has become more available as lenders become better capitalized and more confident and the financial condition of borrowers improves. The result has been a pick-up in the construction of houses and production of cars and other consumer durable goods. With fiscal policy restraint on the growth of spending expected to abate, many economists believe that sustained strength in private demand will lead to an acceleration in GDP over the second half of the year and beyond.

The progress, albeit slow, made to date on putting people back to work in the U.S. and that expectation of a pick-up in growth has in turn led to questions—both inside and outside the Fed—about an exit from unconventional monetary policies. This discussion and the market reaction to it have highlighted a number of issues the Fed, and ultimately other central banks, will need to confront as their economies strengthen and they prepare to wind down their unconventional policies.

Shifting the direction of policy is never easy. It requires a judgment that the previous risks to the economy and price stability have dissipated and that policy can be altered without undermining achievement of the central bank's objectives. The decision about when to exit will be more difficult this time around: it follows a long period of disappointing economic performance, making it hard to have confidence that adequate expansion can be sustained without unusual policies; policy interest rates are essentially zero, reducing the room for responding to further downward shocks, unexpected changes in market rate expectations, or errors in judgment reflected in too-early exit; the associated long period of extraordinarily low interest rates may have induced financial investment decisions that will result in losses and possibly even threats to financial stability as interest rates are raised; the exit will involve multiple dimensions of central bank policy—i.e. balance sheets as well as target interest rates—and adjustments to a number of instruments, not just the calling out a new level of a targeted short-term interest rate; and higher interest rates and reduced remittances from the central bank will increase pressure on the fiscal authorities at a time when longer-term budget trajectories may still not be fully sustainable.

For the U.S., three separate but related decisions are required for exit: when to stop expanding the portfolio through QE, when to raise interest rates, and when or even whether to sell down the longer-term securities acquired in the process of QE. All of these will have effects on longer-term interest rates, exchange rates, and asset prices. Asset purchases and portfolio expansion have certain drawbacks—possible exit complications, central bank exposure to duration risk, extra risk to financial stability because of low or negative-term premiums—that are not inherent in low interest rates and the guidance about how long they will stay low. As a consequence, and with the marginal benefit of such *purchases* seen to be diminishing, they *are likely to be stopped or tapered off when economic expansion is strong enough to put underutilized resources back to work over time, but well before the economy threatens to overheat.*

The decision to actually tighten monetary policy—to raise rates and possibly reduce or sterilize excess bank reserves—should be geared to the risk of overheating and of a sustained rise in inflation above target. For this decision, the cost of exiting too early, of raising rates and then seeing the economy slow more than desired, would seem to exceed the costs of being too late, allowing inflation to rise more than anticipated. Central banks know how to deal with inflation through tighter policies; we have seen over recent years the difficulties faced when trying to ease policy to encourage growth when interest rates are already very low. The Fed appears to have embodied this view of the appropriate risk management in its thresholds for considering a rate increase—an unemployment rate of 6.5 percent, provided inflation is not predicted to be more than 2.5 percent, a 0.5 percent above its target.

Sales of longer-duration securities on the books of central banks are not necessary to tighten monetary policy. Central banks can effect a tightening of policy by raising the interest rate they pay on deposits at the central bank, which should provide a floor for short-term market interest rates and in turn, tighten financial conditions more generally as longer-term rates, exchange rates and asset prices respond to actual and expected short-term rates. If the securities are not sold, they will run off slowly as they mature, and central banks could well need to deploy means of converting reserve deposits to other types of liabilities in order to firm up the floor and gain better short-run control over short-term interest rates. If the securities are sold, longer-term rates will rise more quickly, tightening financial conditions and short-term rates will need to rise more slowly to achieve the same degree of restraint.

The role that domestic financial stability considerations should play in the monetary policy exit is difficult. Without a doubt, the financial collapse that accompanied the pricking of the housing bubble in the U.S. made the recession far worse and more widespread—affecting economies around the world that were otherwise sound. We need to make sure that doesn't happen again; the question is how. Particularly in the current circumstances, as implied by the preceding paragraph, raising interest rates on the early side to forestall bad financial decisions partly induced by very low rates could have especially adverse consequences on achieving inflation and output objectives. *Using regulation and supervision to detect vulnerabilities and build a more resilient financial system would seem far preferable to tightening monetary policy in order to head off threats to financial stability, although monetary policy in the form of earlier exit should be kept in reserve if other techniques don't prove effective.*

We've already seen that the decisions of industrial world central banks to undertake unconventional polices and shifting expectations about when they might exit have had important effects on a variety of financial markets globally. Various economies are facing different challenges and responding to different shocks. So, naturally, they find themselves in diverse cyclical positions with respect to the outlook for inflation and for economic activity, requiring monetary policy paths keyed to their individual circumstances and objectives. *Exit from unconventional polices will occur at different times and at different rates. It could occur in industrial economies when emerging market economies are struggling to keep growth up. And that unavoidable lack of consistency across jurisdictions will result in volatility in interest and exchange rates and spillovers from one jurisdiction to another*—just as the entry into unconventional policies, and in fact monetary policy adjustments under more normal circumstances, have had effects on other financial systems and economies.

The exit from unconventional policies might be especially disruptive given rates being as low as they will have been for as long as they will have been. Nonetheless, *individual central banks cannot be expected to steer away from the domestic objectives embodied in treaty, law, or remit*—say by deliberately running inflation above or below the price stability objective—*to help other jurisdictions reach their own domestic objectives.* And it is not in the interest of the global economy for major countries or currency areas to risk instability of prices or output that would come from a failure to optimize policy on domestic objectives, taking account, to be sure, of the feedback from the global situation onto the domestic economy. So, except for this feedback mechanism, decisions to exit should not be keyed to the consequences for foreign markets and economies.

It is up to authorities everywhere to adapt the regulation of their financial sectors and their monetary policy to protect themselves from any adverse consequences of the monetary policy actions of a major participant in the global markets for goods and services and capital. Financial sectors need to be monitored as to whether they are exposed to a sudden increase in volatility or in interest rates or exchange rates globally, and strengthened by requiring higher capital and liquidity and improved risk management if indeed they might not be resilient enough. Central banks need to be ready to adjust their monetary policies and to let their exchange rates move as required, to counter any undesirable tightening of financial conditions as other central banks exit unusual policies. In general, a rise in both interest and exchange rates for the exiting country will be part of the stabilizing process that heads off inflation pressures. Other countries will experience both a depreciation of their currencies and a rise in interest rates—probably smaller—with opposite effects on output and ultimately inflation. They must decide whether the net of those two influences requires a policy adjustment. That's not to argue that there might not be alternative policy mixes involving broad policy adjustments across many jurisdictions that would help everyone to achieve their own domestic objectives in the context of greater global stability. The objective of IMF spillover exercises is to highlight the interdependencies and potential for different policy mixes to be helpful to global economic stability. Getting the global economy to fuller levels of resource utilization in a sustainable configuration continues to require more domestic demand from surplus countries to replace the lower domestic demand and borrowing from deficit countries, whose over-spending and over-borrowing contributed to the crisis.

Communication about exit plans will be critical in keeping the financial markets and the economy on track, in order to achieve the central bank's goals for output and inflation. The effectiveness of unconventional policies rests importantly on the influence of central banks over expectations in financial markets and among households and businesses. Communication is key to keeping those expectations aligned with the thinking and goals of the central bank and avoiding unnecessary volatility and counter-productive movements in financial conditions. Among other things, keeping longer-run inflation expectations anchored requires the public to have confidence that the central bank has the tools and the will to exit in a timely way. Furthermore, other authorities both at home and abroad can use the communications of the central bank to anticipate and plan for exit.

Clear communication about plans for exit is difficult and faces limitations that are not always adequately recognized. Exit will be complex, involving multiple tools being exercised at different times. A diversity of views about the timing and techniques of exit within each central bank can undermine attempts to convey an unambiguous story of plans. An actual exit will depend on economic developments, many of which cannot be predicted with any confidence. Plans must be adapted to unexpected circumstances and to the evolving nature of the central bank balance sheet. We have seen in the reaction of markets to Fed statements about possible tapering down of its security purchases just how difficult clear communication can be. But it is essential that central banks keep trying to clarify their intentions and how their planned actions depend on shifting projections about prices and activity. The alternative of failing to communicate would be even more volatility and unintended consequences at a time when, with short-term rates already at zero, there is little room for maneuver if financial conditions tighten more than is consistent with progress toward objectives.