

## **Central bank exit policies**

**Panel remarks by Athanasios Orphanides, Governor of the Central Bank of Cyprus**, at the Shadow Open Market Committee Meeting on "Exit Policies for Sound Central Banking"

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A few years ago, when I was on the official staff of the Federal Reserve Board, I was asked to participate in an ECB Watchers meeting in Frankfurt. One reason why I was invited, and a reason I found it attractive, was that I could offer an outsider's view from within the central banking community, complementing the perspectives of ECB insiders at that meeting. I did not realise at the time that I was also setting up myself for this meeting of the Shadow Open Market Committee (SOMC). I was familiar with the long history of SOMC meetings and knew that they did not involve Fed insiders at all. So when my friend and former Fed colleague Gregory Hess told me that a Fed insider would participate for the first time and then invited me to offer an outsider's view, it was hard not to accept the invitation. After all, it would be only fair to return the favour from the other side of the Atlantic. So it is with great pleasure that I address this meeting of the Shadow Open Market Committee on exit policies for sound central banking.

Since last September, we have experienced the most severe global financial crisis in the last 60 years. Central banks have reacted promptly and decisively, thus minimising the risk of a protracted economic slump similar to that experienced during the 1930s. In doing so, some central banks have found it appropriate to resort to unconventional measures to supplement their traditional interest rate policy responses. And for this reason, the exit from these unconventional policy measures for monetary policy is of considerable interest. I should clarify, however, that talking about this topic should not be misinterpreted as suggesting that now is the appropriate time to exit from unconventional monetary policy measures. In the euro area, following the sharp economic decline in the fourth quarter of last year and the first quarter of this year, there are increasing signs of stabilisation but the outlook remains uncertain. Now is not the appropriate time to exit. Nonetheless, it is important to communicate that an exit strategy exists and that it can and will be implemented when the time is appropriate. With this in mind, in my brief intervention I will address some of the questions posed by the organisers of this panel discussion. Before proceeding, I would like to note that the views I express are my own and do not necessarily reflect the views of my colleagues on the Governing Council of the European Central Bank.

By definition, unconventional policies are termed 'unconventional' because they are not frequently encountered and implemented. There are a number of different and not mutually exclusive ways to think about unconventional policies depending on their economic impact and the reasoning behind their adoption. Some unconventional policies may be introduced to improve market functioning. Others, may be introduced primarily to supplement traditional monetary policy easing. Differences in the structure of the economy and institutional arrangements may make different unconventional measures more appropriate and/or more successful in different economic areas. For example, if banks are the most important source of financing in an economy, as is the case in the euro area, unconventional measures focusing on enhancing credit may be the most effective. For other economies, alternative interventions, such as support for the commercial paper market and money market mutual funds may be more appropriate.

ECB President Trichet has described the ECB's unconventional policies as "enhanced credit support" since these policies enhance the flow of credit in the economy over and above what could be achieved through policy rate reductions alone in the face of the financial turmoil (Trichet, 2009). As Trichet states, the ECB's enhanced credit support comprises five elements:

- the full allotment of banks' demand for liquidity at fixed rates
- the provision of liquidity in foreign currencies
- the expansion of the list of assets accepted as collateral
- the lengthening of the maturity of liquidity provision
- the direct purchase of covered bank bonds.

The first two of these measures were introduced initially to address the seizing up of the money market and malfunctioning of the international swap market, which was important in light of the currency mismatch in banks' balance sheets. The expansion of the list of assets accepted as collateral provided additional assurance to banks that they could refinance assets that had become less liquid during the turmoil. The lengthening of the maturity of liquidity provision facilitated better liquidity planning by banks over longer horizons and served to depress term-premia in money market rates. And finally, the purchase of covered bank bonds was a direct action in financial markets that improved market functioning in the covered bond market leading to smaller spreads over comparable government securities.

The unconventional policies that have been implemented as a result of the financial turmoil can, as already mentioned, be thought of as serving one or both of the following two related functions. First, to facilitate liquidity provision and improve market functioning, in other words to restore the transmission mechanism thus contributing to financial stability. And second, to influence the stance of monetary policy beyond what is normally reflected in the setting of the very short-term nominal interest rate, which serves as the traditional monetary policy tool. Conceptual separation of these two functions may be useful for understanding the timing and circumstances for the adoption or the exit of any particular unconventional measure. A measure adopted to improve the functioning of a particular market may become unnecessary when that market improves, in which case exit from that unconventional measure would be warranted. On the other hand, the traditional considerations determining the appropriateness of an easing or tightening of monetary policy under normal circumstances would be pivotal for the adoption and exit from a measure adopted primarily to influence the stance of monetary policy.

When short-term nominal interest rates are not close to the zero lower bound, the first consideration is the more important determinant. For example, the primary function of the full allotment of banks' liquidity demand by the ECB in October 2008 was to address the dysfunction of money markets. In other words, the primary purpose was not to engineer a monetary policy easing, although it did obviously contain the deterioration in monetary conditions arising from market difficulties. In the light of the deterioration of economic conditions, monetary policy was also eased by aggressively reducing the ECB's main policy rates in the months since October 2008.

In contrast, when short-term nominal interest rates are close to zero, unconventional policy measures can be employed with the primary purpose being to engineer additional monetary policy easing. Such measures could include increasing the size or changing the composition of a central bank's balance sheet by, for example, purchasing assets such as covered bank bonds. They also include engaging in operations that have a bearing on interest rates with maturities beyond the very short term, for example the provision of long-term liquidity, such as 6- and 12-month maturities at the same interest rate offered for shorter maturities. These measures induce additional monetary policy easing by reducing credit and term spreads.

Indeed, as policy rates get close to the zero lower bound, they may no longer suffice as the best indicators of the monetary policy stance. Movements in interest rates at longer maturities that are not as close to the zero bound, for example money market

rates at maturities of 3-, 6- or 12-months, may become more informative regarding the stance of monetary policy..

As already mentioned, the utilisation and exit from an unconventional policy measure adopted primarily to influence the stance of monetary policy near the zero lower bound will be determined by similar considerations to those determining a conventional policy easing or tightening. In the case of the ECB, the clarity of our price stability mandate is pivotal for these decisions.

Our mandate has not changed in light of the crisis. First and foremost, our goal is to ensure a continuing environment of price stability in the euro area, by which we mean a stable rate of inflation close but below 2 percent a year. Price stability is the best way to ensure maximum sustainable growth in the long run. High inflation as well as deflation are undesirable and inconsistent with our mandate.

In light of the lags associated with the monetary transmission mechanism, policy must be forward looking. This is the reason why the monitoring of inflation projections and inflation expectations over various horizons are critically important. If inflation projections and expectations suggest that inflation is likely to remain subdued and significantly below 2 percent for a considerable time, then it would be appropriate to ensure sufficient monetary policy accommodation is in place to minimise the threat of deflation and to restore price stability. If, on the other hand, inflation threatens to rise above our definition of price stability, the appropriate tightening would be warranted to ensure price stability.

The high degree of anchoring of long-term inflation expectations we have observed in the euro area in the light of the financial crisis has been reassuring. However, partly due to the large swing in energy prices over the past two or so years, actual inflation as well as inflation expectations at the policy relevant horizon have been more volatile than usual and are currently below our definition of price stability. Going forward, continued monitoring of inflation expectations is of the essence.

A final issue I wish to mention is that of the increased uncertainty facing policymakers in the current environment. Over the past several decades, our experience with very low policy rates and unconventional policies is rather limited, and for some policies non-existent. As a result, we face greater than usual uncertainty about the multipliers and transmission lags of our policy measures. In such an environment, the risks that one may misjudge the appropriate timing and force of policy action become greater.

One risk is that of removing policy accommodation too late. If so, inflation would rise above our price stability objective. This is particularly the case when the money multiplier rises from a historical low and thus excess liquidity starts being converted into credit. A second risk is that of removing policy accommodation too early. History suggests that this latter error may be extremely costly in an environment with inflation below a central bank's definition of price stability. Two well-studied historical examples of apparently premature tightening by exiting from unconventional policy measures are those of the Federal Reserve in 1937 and the Bank of Japan in 2000<sup>1</sup>. The risks of removing policy too early and too late have to be appropriately balanced for policy to be successful.

In conclusion, talking about an exit strategy should not be confused with its implementation. Now is not the appropriate time to exit. But the process would begin when there are clear signs that markets are functioning properly, the economic recovery is firmly under way and, therefore, upside pressures on inflation appear. As with all monetary policy decisions, safeguarding the central bank's primary objective of price stability will be the determining factor regarding the exit from unconventional monetary policy measures.

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<sup>1</sup> Friedman and Schwartz (1964) and Meltzer (2002) examine the 1937 Federal Reserve error in detail. Orphanides (2004) compares the Federal Reserve policies leading to 1937 with those of the Bank of Japan in 2000.