Unconventional Monetary Policies for EMDEs: Uses and Consequences

Practical Questions and Some Answers

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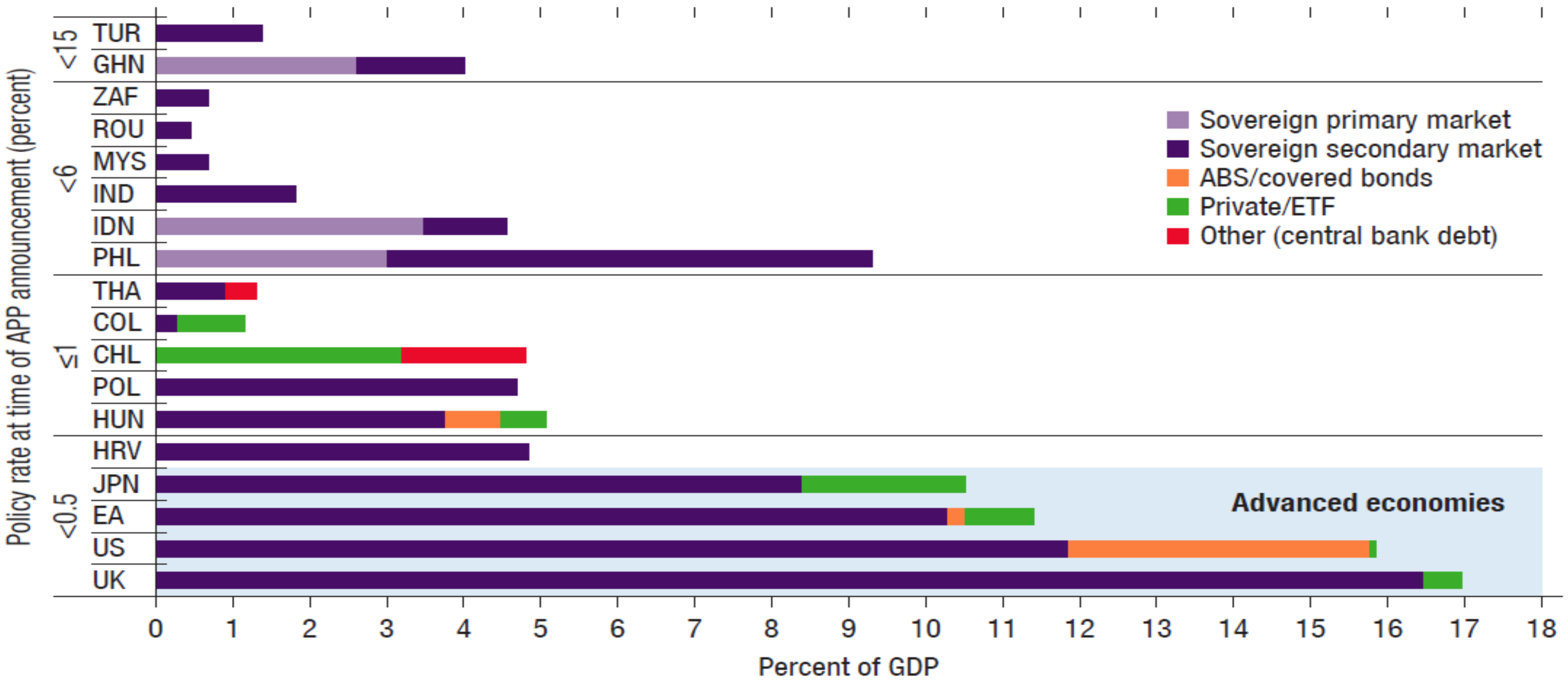
Key Takeaways

I am an EMDE. May I do unconventional monetary policy (UMP)?

- Yes. If you can do conventional monetary policy (CMP), you can also do the unconventional variety. Monetary policy by any other name is as implementable
- Better question is whether you should
- If you will do so, be clear on purpose: monetary or financial stability?
- Different types of UMP are appropriate for different situations
- Do not attempt at home before understanding the channels of operation and the risks associated with UMPs

EMDE UMPs are possible and have happened

Figure 1. Central Bank Asset Purchases



Sources: Central banks; national sources; and IMF staff estimates.
Note: Data are March 2020–March 2021. Primary market purchases for the Philippines refer to the repurchase operation with the central government. Advanced economies asset purchase figures are calculated using the change in holdings, where applicable. Ghana's secondary market purchases refer to a one off operation with a state-owned bank, rather than a regular purchase operation. ABS = asset-backed securities; APP = asset purchase program; ETF = exchange-traded funds.

Outline

A. What differentiates UMP from CMP?

B. Reasons to use UMP

C. Types of UMP and their uses in EMDEs

D. Country cases (Skipped in this talk)

E. Risks of UMP

F. Wrapping up

A. CMP vs UMP

- What is conventional monetary policy (CMP)?
- Depends on who and when you ask
- Non-convertible money would be unconventional until 1970s, inflation targeting would be unconventional until late 1990s
- Today: Central bank policies other than changing the policy instrument are labelled unconventional
  - Balance sheet policies/LSAPs
  - Asset purchases
  - Forward guidance
  - Negative interest rates
- Anything that was not in the standard playbook before the GFC

A. Are these really different ?

- Depends. An LSAP is an OMO. Forward guidance is a monetary policy announcement.
- At a high enough level of abstraction all policies are central bank policies—none are unconventional.
- From an implementation, effectiveness, and risks perspective, there is a reason why the standard CB playbook was standard.
- Unconventional policies are less tested, less easy to understand why and how they work, more likely to have distributional effects, and more likely to involve economic and political economy risks for the central banks involved both when undertaking (e.g., QE) and when being unwound (e.g., QT).
- Monetary Policy Committees are not set up to consider distributional questions (including targeted lending), so less confident and more open to criticism when employing some UMPs.

B. Reasons to use UMP

- What do central banks normally do?
  - Cyclical monetary policy
  - Financial stability
  - Various other (growth, BoP targeting, climate change…)
- Why do they do that?
- What are the tools?
- How does CB differentiate between instrument and purpose?
- What do central banks do in extraordinary times?
  - When shocks are extraordinary?
  - When standard tools are extraordinarily constrained?

B. Normal times

- Central banks do cyclical control
- Target output gap and inflation (and more), using policy rate
- Why two (or more) goals for one tool? Why not delegate one to fiscal policy?
- Great question, answer is political economy rather than economics
- CBs may be overburdened in normal times as well
- Financial stability actions not undertaken in normal times (no need)

B. Extraordinary times

- Extraordinary times:
- GFC/Covid impulse—financial market dysfunction
- SVB aftermath—bank liquidity provision

- Constrained tools:
- ELB QE
- Forward guidance

- Same tool may have different uses in different times…asset purchases may be for financial stability or for cyclical stimulus.

B. Use and transmission of UMP

- Market distress use is easy, CB is either lender or buyer of last resort to financial counterparties. Not so different from FX intervention.

- Forward guidance is also easy. FG effectiveness needs to clear a much lower hurdle than IT. Central bank should be able to commit to its own action, not an outcome.
  - FG has been used by central bankers for a long time, much before the term was coined.

- QE is easiest to administer (buy long term bonds in auctions) but hardest to understand.
  - Neutral in standard macro-finance theory
  - Signaling and balance sheet channels both relevant.
  - Require either less than perfectly credible central bank and/or segmented markets.
  - Most likely both are present.

C. Types of and reasons for using UMP

- Financial market dysfunction:
  - Central bank as liquidity provider
  - Central bank as counterparty of last resort
- We have seen both in the recent past
  - Increases the size of CB balance sheet – Fed and ECB have both indicated recently some concerns re balance sheet size and need to normalize
  - Changes its composition
    - Liquidity provision—more reserves as liabilities, more government bonds as assets (MonPol goal)
    - Market making—more reserves as liabilities, more non-Treasury securities (and sometimes non-fixed income) as assets (Financial Stability goal)
  - Well understood use. Counterparty of last resort is backstop to firesales, bank runs.
- Many are now part of the CB toolkit, will not be unconventional next time they are used.
  - Relatively short-term and easy to unwind.
- Straightforward use for EMDEs.

Types of and reasons for using UMP, cont'd

- Constrained policy tool
  - The aim is standard expansionary policy but the regular policy tool is constrained, as in ELB.
    - LSAPs, QE
    - Forward guidance
    - Negative rates
  - Forward guidance and negative rates are easy to understand, QE seem to work to some extent in practice, requires various market imperfections to understand why it works in theory.

C. The other use of UMP

- Blatant monetization of debt—creating fiscal space…or at least attempting to. (Indonesia, Philippines, Ghana, Nigeria)
- Lower interest rates might do the job, unless yield curve steepens sharply. If it does steepen, can UMP remedy? Is this financial repression?
- If action genuinely short-term and limited, use of government overdraft (if facility exists) at CB should suffice.
- But UMP may be utilized at ELB or be targeted.
- Effectively treats the CB as a fiscal agent.
- May be useful, especially when external shock is large (Covid) and/or inflation below target.
- Has the obvious risk of leading to fiscal policy dependence on continued CB support and fiscal dominance.
- Does CB have sufficient credibility for market to believe that action is one-off?

D. Case Studies: South Africa and Thailand

South Africa and Thailand

- SSAPs used: limited in time and in volume, CB communicated very clearly to market what it was doing and why. Net credit to government *fell* during COVID period. CB policy rate not constrained by fiscal pressure

1. South Africa
    1. Inflation targeter, with floating exchange rate (with growing level of FX reserves); monetary policy rate raised in line with rising COVID period inflation (currently above long-run levels)
    2. Government debt rose by some 15% of GDP 2019-2021 to 70%, but central bank net credit to government fell during this period (and had already been negative)
    3. Small amount of SSAPs undertaken early 2020 for limited period

2. Thailand
    1. Inflation targeter, with occasional use of two-way FX intervention; stable FX reserves, moderate inflation level with well-anchored inflation expectations
    2. Government debt rose by nearly 20% of GDP 2019-2021 to 53%, but net credit to government remained negative
    3. Negligible SSAPs undertaken early in 2020 for limited period; some use of “funding for lending” schemes.

D. Case Studies: Indonesia and Philippines

Indonesia and Philippines

- Went beyond SSAPs – asset purchases larger and prolonged

1. Indonesia
    1. Central bank law changed to allow primary market purchase of government securities, but only under clearly-defined and approved “emergency situations”.
    2. Central bank credit to government accounted for over half of the 10% increase in government debt during the COVID period, though NCG rose by only half this amount and government debt is relatively low; program of purchases ended in 2022 as planned.
    3. Some FXI, but flexible exchange rate and stable FX reserves, relatively low inflation in recent years

2. Philippines
    1. Some exchange rate weakening during COVID period and recent drop in FX reserves, history of somewhat volatile inflation level; policy rate may have lagged continuing rise in inflation but recent increases have helped to avoid further Peso depreciation and anchored inflation expectations.
    2. Government debt rose nearly 20% of GDP 2019-2021 to 57%; central bank net credit to government, already positive, rose by 2% of GDP and undertaken over a more extended period than SSAPs.

D. Case Studies: Ghana and Nigeria

Ghana and Nigeria

1. Ghana. Excessive borrowing by government resulted in high real interest rates and high currency-risk premia (exacerbated by unpredictable ER policy?), and eventual government default coupled with ER collapse and inflation jump; some direct CB credit to government exacerbated but not prime cause of problems
    1. Managed ER until 2022, when government debt problems led to sharp depreciation of Cedi and jump in inflation to around 50%, monetary policy rate turning negative in real terms for first time in 15 years; recent sharp drop in FX reserves
    2. Government debt rose by 30% of GDP 2019-2021 to nearly 90%; central bank net credit to government, already positive, rose by over 6% of GDP in this period as government has relied increasingly on CB credit, countering CB efforts to tighten monetary policy stance.

2. Nigeria. CB has long history of ER manipulation, leading to long-standing parallel FX market and continual expectations of depreciation; and periodic credit to government (including when ER manipulation led to shortages, and non-resident investors afraid of domestic market).
    1. Poor MP rather than UMP, which has failed to deliver goals of CB.

D. Case Studies

- Sample EMDE central banks - Recent Experiences

  - South Africa, Thailand operate IT regimes, have strong credibility, and avoided any credit to government despite high budget financing needs during COVID period, while engaging in limited SSAPs to tackle short-term financial market dysfunction
  - Indonesia, Philippines engaged in limited degree of monetary financing; not yet full IT regime; too early to be confident that no “collateral damage” from limited use of UMP
  - Ghana, Nigeria appear more prone to monetary financing, unsustainable ER management, and less monetary policy independence; poorer out-turns for inflation and central bank credibility

- Conclusion: argument that “to the extent EMDE central bank can undertake CMP independently, it can undertake UMP” appears to hold true for these country case studies.

E. Risks

- Balance sheet risk to the CB
  - Default risk if no credible government guarantee (US Treasury provided first-loss capital to Fed vehicles; UK government guaranteed BoE against losses – and has paid out)
  - Interest rate risk
  - CB capital and fiscal capacity to recapitalize (or forgo transfers) becomes important
  - Changes balance of power between CB and Treasury
- Political risk due to distributional effects
  - Interest on reserves is conspicuous
  - Buying “these” assets but not “those” becomes an issue
  - Why help Wall Street so openly and not Main Street?
- Forward Guidance may be taken as a commitment
  - CB credibility may hinge on following a clearly “wrong” path because the public took FG as commitment
- UMP to create fiscal space, or UMP that has the side effect of creating fiscal space may give fiscal policymakers ideas
  - EMDE central bankers grow up with the fear of fiscal dominance for a reason
  - Argentina, Zimbabwe (= CBs from A to Z) clear examples of “What could go wrong”. Could add Lebanon, Sudan to list.

F. Wrapping up

- CMP and UMP are not all that different.
- If you can do one, you are most likely to be able to the other.
- But CMP is conventional for good reason.
- Unless UMP is justifiable by some extraordinary external reason, EMDEs are best served by good CMP.
- FSP (financial stability policies) are nearly always unconventional, taken in crisis times to meet particular situations.
  - But they need to be cautiously structured, clearly communicated, and come with some sort of exit plan to not turn into enablers of weak fiscal policy.