Unconventional Monetary Policies: Their Scope and Effectiveness

Prof. Michelle Alexopoulos

University of Toronto

September 14, 2017

Broad Categories

- Forward Guidance
- Balance Sheet related policies (e.g. QE, Operation Twist)
- Negative interest rates

Do they work?

Some Empirical Support

Forward Guidance can:

- Impact expectations of the future path of policy rates
- Improve the predictability of short and medium-term yields over the near term
- Affect markets, and exchanges rates

*See e.g., evidence in Gurkaynak, Sack, and Swanson (2005), Campbell et al (2012), Charbonneau and Rennison (2015), and Swanson (2017)

Some Empirical Support

QE/Balance sheet type polices:

- Have long-lasting effects on longer term interest rates on a variety of securities (e.g., Treasuries, mortgage-backed securities and corporate bonds)
- Affect exchanges rates
- Raise GDP and
- Increase inflation

See e.g., D'Amico and King (2010), Krishnamurthy and Vissing-Jorgensen (2011), Hamilton and Wu (2012), Swanson (2011), Neely (2012), Meier (2009) and Joyce et al. (2011,2012), Chung et al. (2012),

Less evidence about negative rates

- Implementing Negative rates has similar effects to lowering rates (Effects a bit smaller)
- Allowed countries to restore and maintain interest rate differentials
- Helped ease exchange rate pressure on SOE
- Lowering further may trigger issues with bank profits, risk taking and financial stability

See e.g., Witmer and Yang (2016), Coeure (2016), Jackson (2015), Tartar (2016), Jordan (2016), Fontaine, Suchanek, and Yang (2017) and the references within

When should we use the new tools?

It depends on the conditions...

- Some form of Forward Guidance is useful in good times and bad

- The others I would only use when we get to the zero lower bound

  - Balance sheet action first

  - Negative rates only as a last resort

Things to consider when using Forward Guidance

1. *Commitment*

2. *Confidence*

3. *Uncertainty*

Things to consider when using Forward Guidance

- Different types of forward guidance

Qualitative type: Message is non-committal about the path

Examples: *Monetary policy will be forward-looking and depend on economic data.*
The policy rate will be maintained for an extended period of time

Newer type: Message is explicit about path of policy

Examples: *Conditional on the outlook for inflation, the target overnight rate can be expected to remain at its current level until date X. (CONDITIONAL GUIDANCE)*

The low range for policy rate will be appropriate at least as long as the unemployment rate remains above x% (THESHOLD/STATE-DEPENDENT)

Forward guidance operates by:

(1) Impacting the term structure of interest rates,

(2) Increasing the predictability of monetary policy, and

(3) Anchoring long-term inflation expectations.

Risk 1: Loss of Credibility

If the Bank unexpectedly deviates when it specifies explicit future actions, its reputation can be affected.

E.g., The bank promises to keep rates low at least until unemployment rate is 6%

New data shows issues with inflation expectations/other issue

Bank Breaks promise & harms future credibility

** Solution is to explain more about when deviations would likely occur i.e., only use CONDITIONAL forward guidance

Risk 2: Individuals misinterpret statements

E.g., The bank promises to keep rates low through date X

**A simple statement by itself doesn’t give much guidance as to why this is done

Option 1: Models suggest it was a good reason

Option 2: Central Bank saw data others didn’t and it foresees poor conditions lasting through date X

**If consumer/firm confidence is adversely impacted, we can see negative economic consequences

Risk 3: Uncertainty

1. Changes in wording can cause policy uncertainty (related to misinterpretation issues)

2. Changes in the provision of guidance may also cause policy uncertainty

Example: July 12 hike vs Sept 6 hike

<u>JULY 12 RATE HIKE</u>

-Bank of Canada communicated rate hike was likely coming

-most people not surprised by move

<u>SEPT 6 RATE HIKE</u>

-Bank of Canada did not provide much guidance

-many people surprised by move

Top Keywords/phases in days following change (Factiva)

JULY 12-18

- *easy-money era*
- *rate hike*
- *interest rate*
- *benchmark interest rate*
- *entire generation*
- *percentage point*
- *key interest rate*
- *economic growth*
- *home equity line*
- *rate increase*

SEPT 6-13

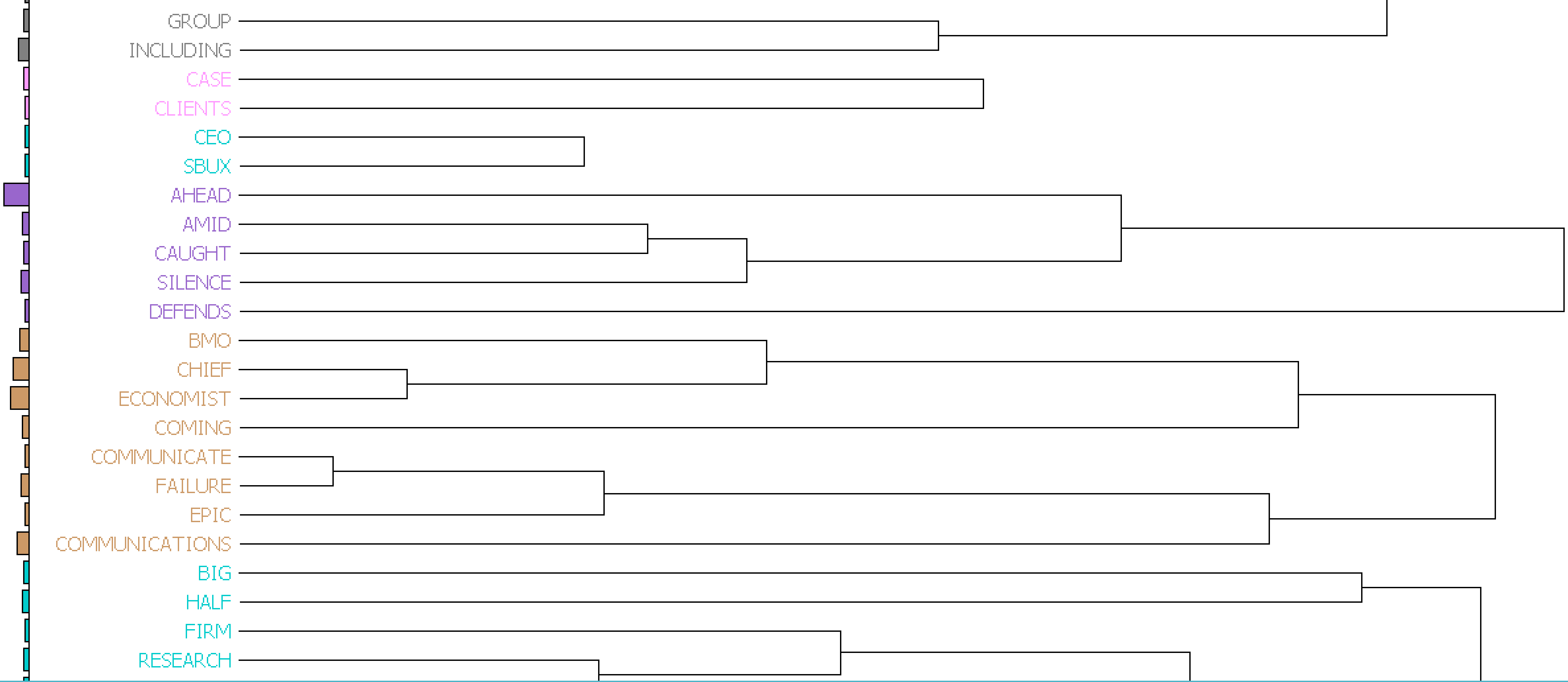
- *rate hike*
- *public silence*
- *rate increase*
- *interest rate*
- *rate move*
- *unexpected force*
- *public remark*
- *economic momentum*
- *quarter-point increase*
- *trendsetting policy rate*

Sample of recent Headlines

*Bank of Canada rate hike leaves critics wondering: Communications failure, or failure to forecast? (*Report on Business, Sept 13, 2017)

Silence ahead of rate move puts heat on BoC (Financial Post, Sept 12)

Bank of Canada Rebuts BMO Charge of `Epic Fail' on Communications (Bloomberg Sep 11, 2017)



Clusters of words in current articles referencing uncertainty and the Bank of Canada

Example of responses to lack of guidance

Excepts from Financial Post’s Silence ahead of rate move puts heat on BoC

- [Doug Porter] blamed the information vacuum for causing a "great deal of uncertainty" and a "fairly violent market reaction.“
- Canadians hadn't heard a peep from the central bank since it raised the rate July 12 for the first time in nearly seven years. Ahead of the July increase, senior officials sent clear signals the bank had shifted to a rate-hiking path. But for nearly two months before last week's announcement, the bank went dark.”
- "What we had here was a failure to communicate - an epic fail," wrote Porter.

Other stark quotes reported in the news also point to increases in uncertainty …

"With an absence of greater communication leading up to that rate hike, we've been thrown into the lurch somewhat as to *how to interpret monetary policy going forward…The* market has interpreted policy going forward one way but the concern is maybe the Bank of Canada hasn't telegraphed that exactly as they would like…If it gets walked back, all we're going to have is more elevated levels of volatility in the Canadian dollar and financial markets in general."

Scott Smith, chief market strategist at Viewpoint Investment Partners.

From: Reuters article, **Bank of Canada defends silence ahead of rate hike,** Sept 12)

Issues of Consistency in use…

“The central bank could stand to be more consistent about what it will and will not communicate, given it signaled ahead of the July hike but not the September increase”, said Dana Peterson, economist at Citigroup.

Dana Peterson, economist at Citigroup (Reuters article Sept 12)

And Misinterpretation of goal?

Another Quote From the Reuters' article suggested the Bank wanted the surprise to scare people…

"If the bank is really tilting against this debt bubble that we have growing in Canada, it really makes sense to scare consumers, to really fire that warning shot across the bow and to indicate to consumers that rates are going up," said Karl Schamotta, director of global markets strategy at Cambridge Global Payments.

Opinion in Bloomberg Sept 13 about the B of Can response to critiques …

The defence offered by the Bank:

1. Makes the Bank of Canada look vulnerable and unsure of itself
2. Risks creating the perception that the bank will respond to economist notes that it doesn't like or that it feels are wide of the mark.
3. Could lead to Investors speculating that the central bank's silence about some economist's note is equal to an endorsement (could be taken as another form of forward guidance)

Conclusions

- *Conditional Forward guidance* and Bank communications **given consistently** over time can be a useful monetary policy tool for all times (Good and Bad)

- Other tools may be useful during times of crisis

- If we are going to use Bank Communications and forward guidance, we need more research on how the messages are interpreted by markets to increase its effectiveness over time

Conclusions

- Advances in AI and machine learning techniques should help researchers with this (tracking sentiment, uncertainty etc.)

- The research will need to be ongoing since text analytics and data mining are currently being used by traders and trading algorithms