Unconventional Policies in an Unconventional World

Mark Lewis
IMF Senior Resident Representative to Turkey

Presentation to the Economic Research Forum Conference :
"An Evaluation of Unconventional Monetary Policies"

Istanbul
April 19, 2013

WHY WERE UNCONVENTIONAL POLICIES NEEDED, AND WHAT WAS DONE?

Why were unconventional policies needed?

- The global crisis challenged conventional monetary policy:
  - Financial disruptions weakened the monetary policy transmission mechanism.
  - Some markets froze.
  - The severity of the recession pushed the optimal policy rate below the zero lower bound (ZLB).

What was needed?

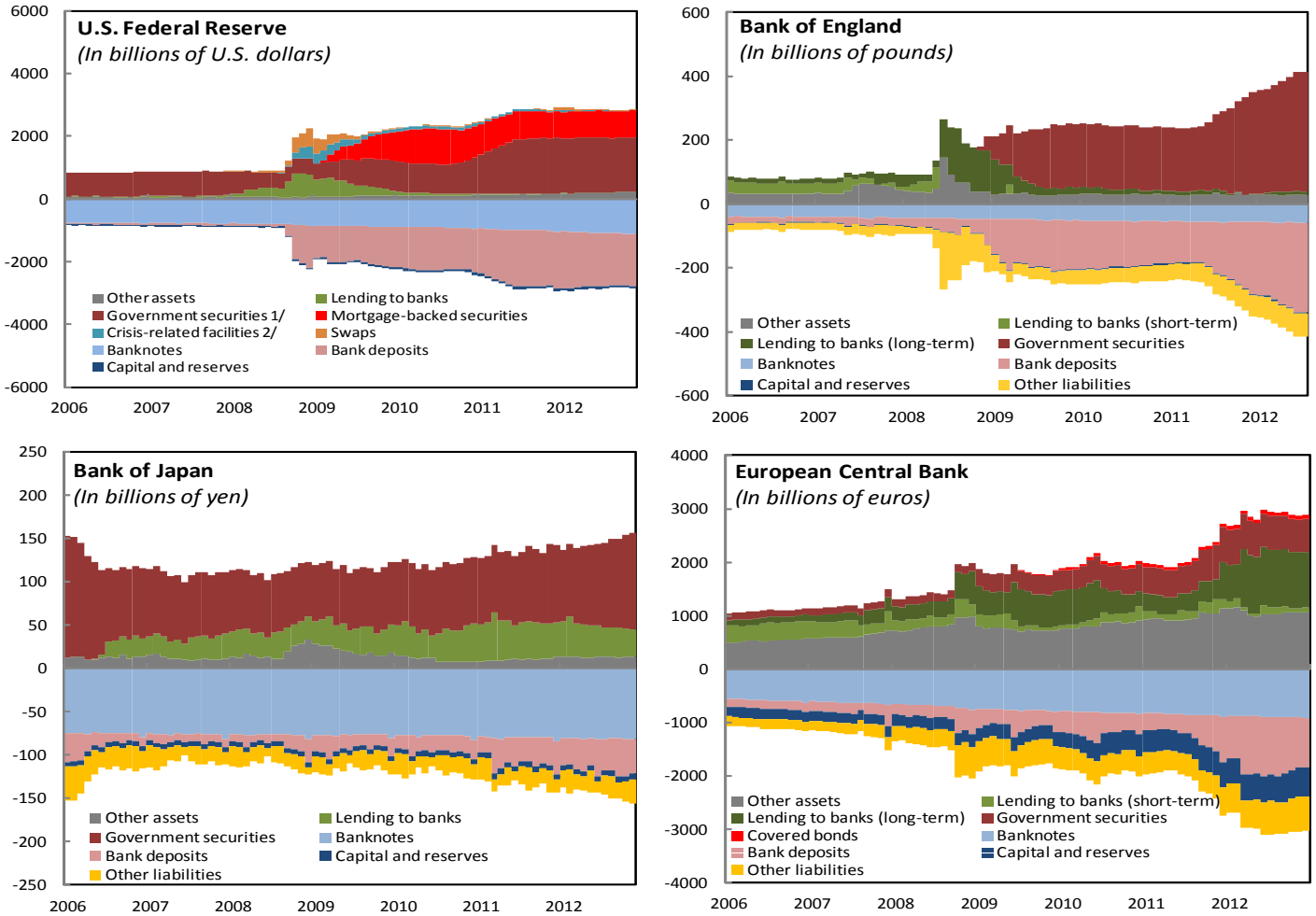
- Restore financial intermediation
  - Central banks expanded role as lenders-of-last-resort.
  - Financial market functioning met through aggressive liquidity provision.
  - Supported financial intermediation, including through purchasing private assets
- Loosening policy beyond the ZLB: target real long-term yields directly through:
  - Forward guidance
  - Purchasing government bonds

Overview of unconventional policies

Type of MP-plus Policy	Examples	Associated Potential Risk
Prolonged periods of low interest rates	Fed (forward guidance) BOJ (forward guidance)	Pressure on the profitability and solvency of financial institutions Excessive risk taking ("search for yield") Evergreening, delay in balance sheet repair
Quantitative easing	Fed BOJ BOE	Dependence on central bank financing
Indirect credit easing	BOE (FLS) ECB (LTRO) BOJ	Dependence on public sector financing Distortion of allocation of credit, possibly weakening underwriting standards Delay in balance sheet repair Reinforcement of bank-sovereign links
Direct credit easing	Fed (MBS, GSE) ECB (CBPP) BOJ (ETF, CB, REIT)	Distortion to prices and market functioning

Source: IMF staff.

Overview of unconventional policies



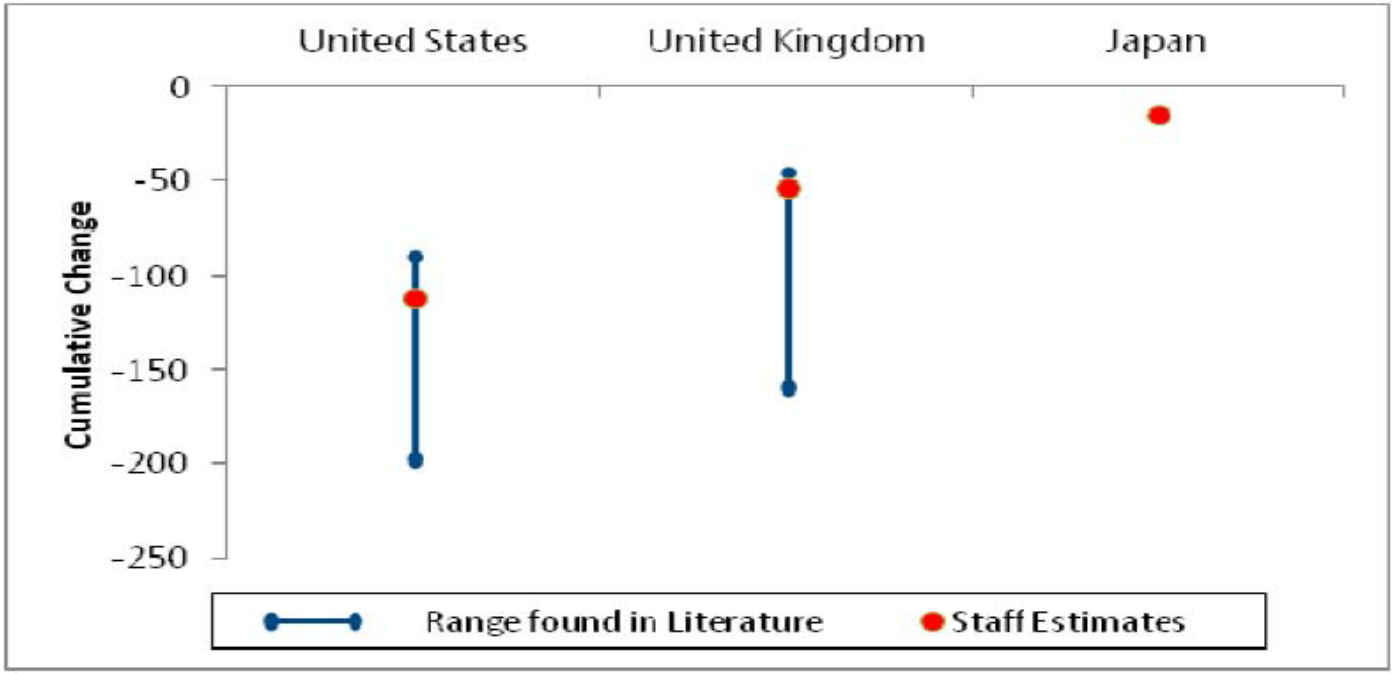
Sources: National central banks; Haver Analytics; and IMF staff estimates.

HOW EFFECTIVE WAS IT?

Policies to restore financial markets were generally effective, as was forward guidance

- Liquidity returned to securitized credit markets in the US
- LTRO avoided major bank deleveraging and credit contraction
- OMT decreased bond yields in euro area countries under stress.
- Empirical evidence suggests LT government bond yields less sensitive to macroeconomic news
- Evidence that tail risks have lessened.
- Forward guidance has been at least partly effective.
- However, financial intermediation remains challenged in the euro area countries under market stress.

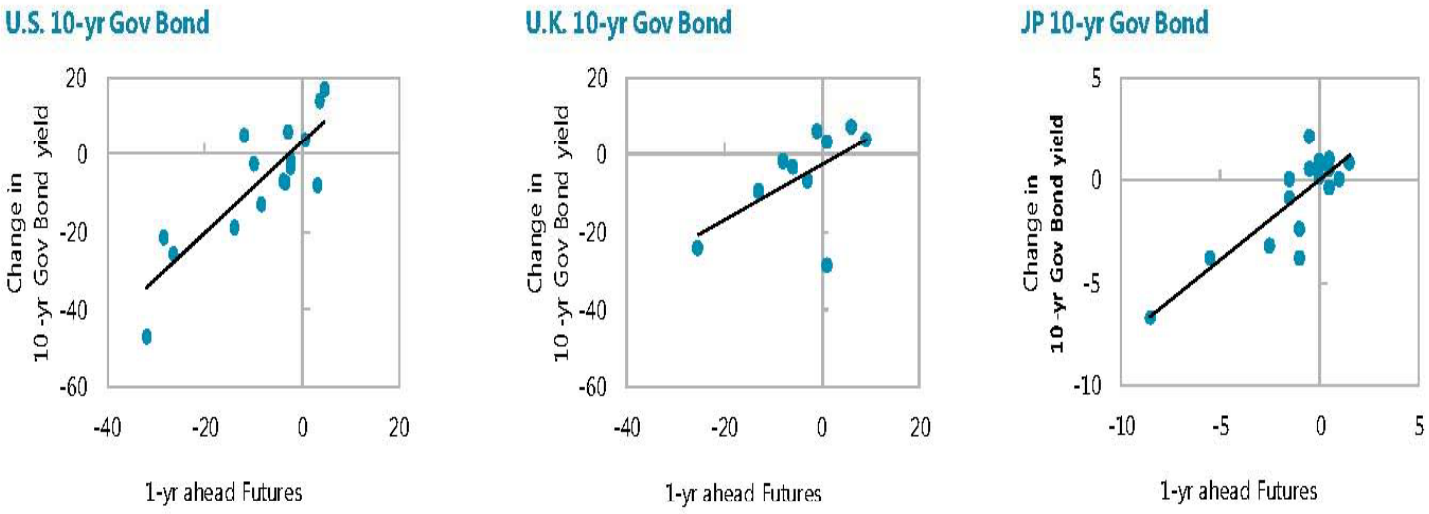
Cumulative effects of bond purchases on 10-Year Government Bonds



Source: IMF staff

A stronger effect if there is more surprise

Yield responses to surprises related to bond purchases, as proxies with futures on interest rates.



Source: Bloomberg.

With caveats, bond purchases improved macroeconomic conditions

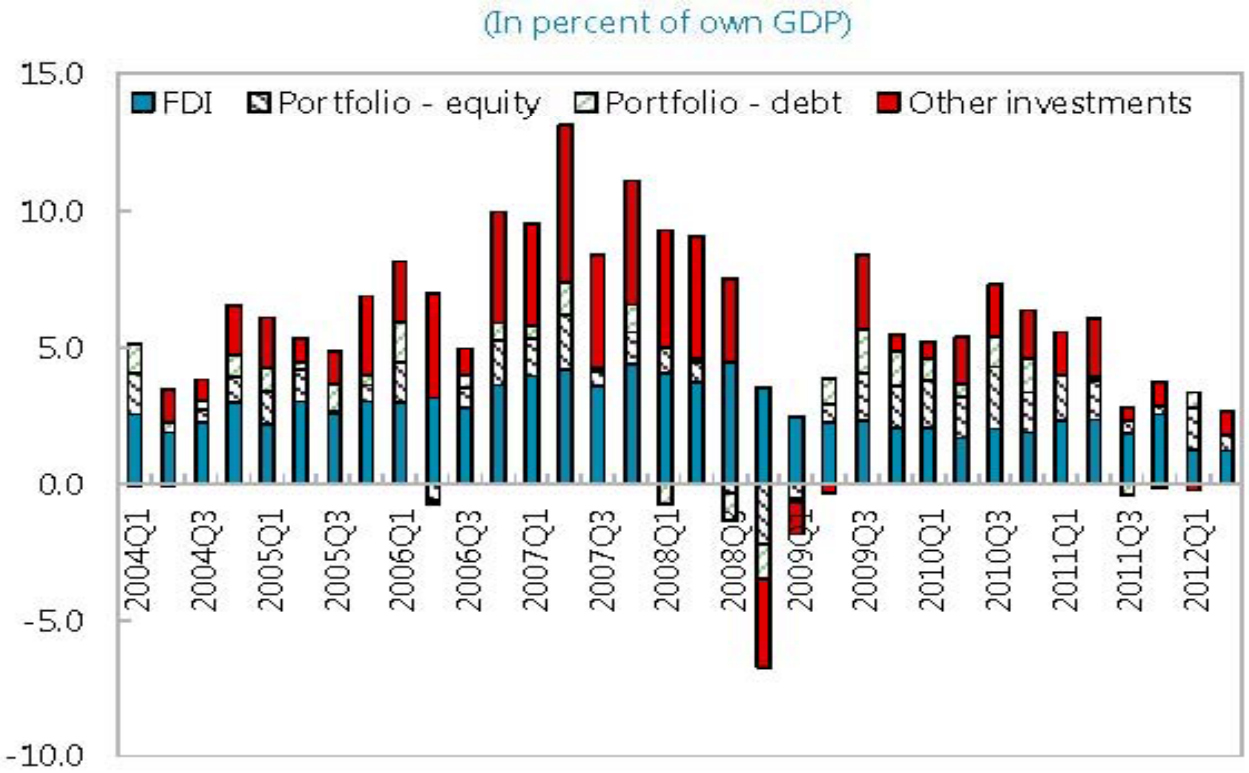
- Summarizing from a range of studies:
  - GDP growth and inflation react positively.
  - The effect is short-lived, although longer for inflation.
  - ➢ Great uncertainty about size of effect, and difficult to disentangle other factors

SPILLOVER EFFECTS

Impact of unconventional policies on capital flows

- Capital flows are a “challenge and an opportunity”
- Foreign financial spillovers largest when:
  - Policies restore market stability; or
  - Change the monetary framework.
  - Although may have limited impact if not a surprise, or signifies a worse global outlook.
- The counterfactual is uncertain: the absence of unconventional policies might have led to much worse economic and financial conditions.

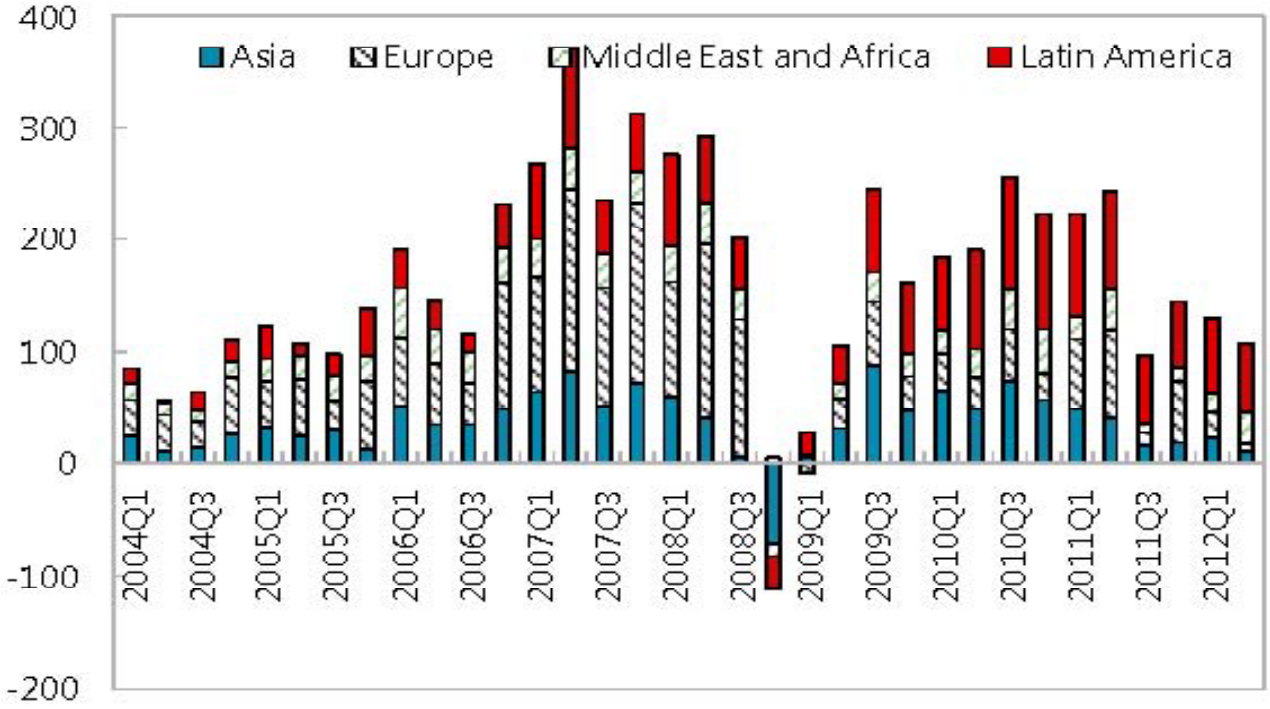
Emerging Market impact: initially, repatriation of capital , notably to the US



Sources: IMF IFS.

The return of capital flows shifted its regional focus among EMs

(In billions of U.S. dollars)



Sources: IMF IFS.

Countries have adopted a range of measures to address capital flows

Selected Capital Flow Management Measures[1]	
Measures designed to limit inflows	
Brazil	2009 - Introduction of a 2 percent tax on portfolio equity and debt inflows.
Indonesia	2011 - Imposition of a six-month holding period on central bank bonds and of a limit on short-term foreign borrowing by banks to 30 percent of capital.
Korea	2011 - Restoring withholding taxes on interest income and transfer gains from foreigners' treasury and monetary stabilization bond investment, leading to equal treatment for both foreign and domestic investors.
Peru	2010 - Increase of fee on nonresident purchases of central bank paper to 400 basis points (from 10 basis points).
Thailand	2010 - Imposition of a 15 percent witholding tax on nonresidents' interest earnings and capital gains on new purchases of state bonds.
Measures designed to limit outflows	
Argentina	2001 - Establishment of *Corralito*, which limited bank withdrawals and imposed restrictions on transfers and loans in foreign currency.
Iceland	2008 - Stop of convertibility of domestic currency accounts for capital transactions.
Malaysia	1998 - Imposition of 12-month waiting period for nonresidents to convert proceeds from the sale of Malaysian securities
Ukraine	2008 - Introduction of a 5-day waiting period for nonresidents to convert local currency proceeds from investment transaction to foreign currency.
Thailand	1997 - Imposition of limits on forward transactions and introduction of export surrender requirements.

[1]This table provides illustrative examples of adopted measures that are assessed to be CFMs. It is not comprehensive and does not assess appropriateness or effectiveness.

WHAT ARE THE RISKS FROM UNCONVENTIONAL POLICIES AND AN EVENTUAL EXIT?

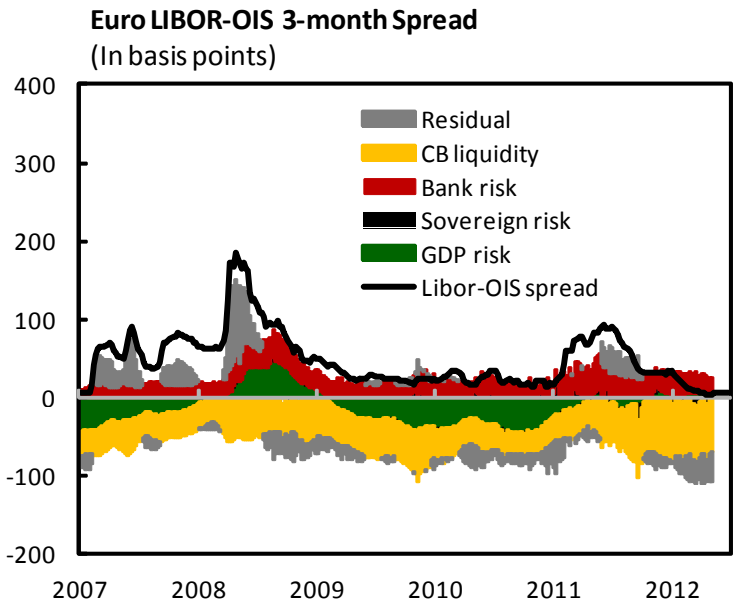
Empirical Findings – Markets

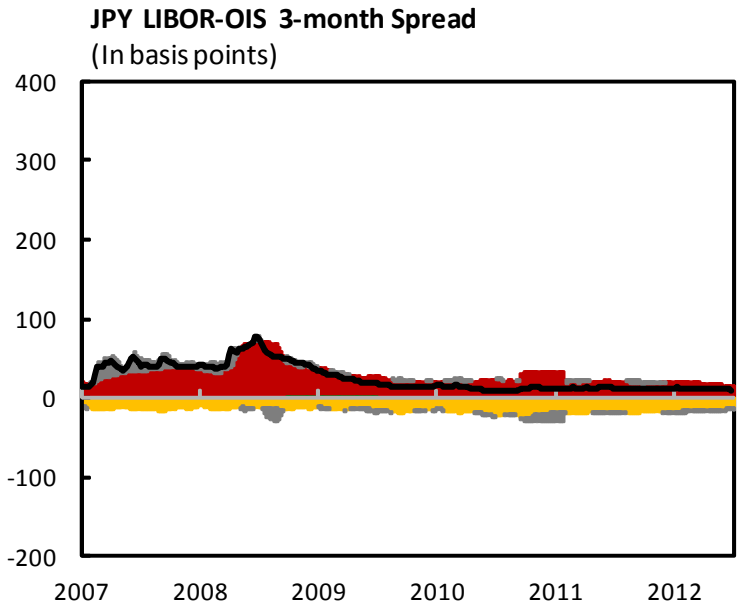
- Question: which risks are emerging and which may become more pronounced over the medium term?
- Main findings:
  - Central banks are major players in mortgage, and government bond markets, and in intermediating interbank funds
  - No evidence of adverse effects on market functioning
  - But risks surrounding exit

Empirical Findings – Markets

Interbank Markets:

- Some counterparty risk spreads still incorporate a central bank support component; exit could lead to higher risk spreads again if underlying issues are not resolved

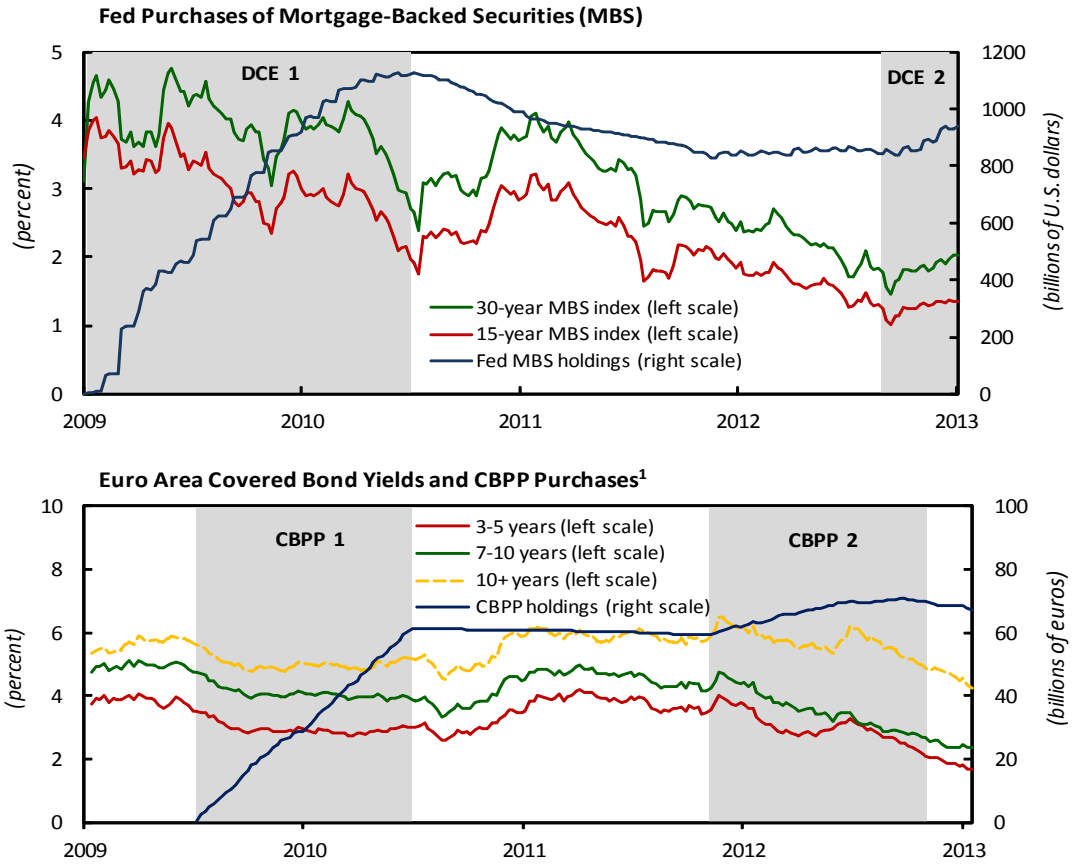




Sources: Bloomberg L.P.; JPMorgan Chase; Datastream; and IMF staff estimates.

Empirical Findings – Markets

Mortgage and Corporate Bond Markets:

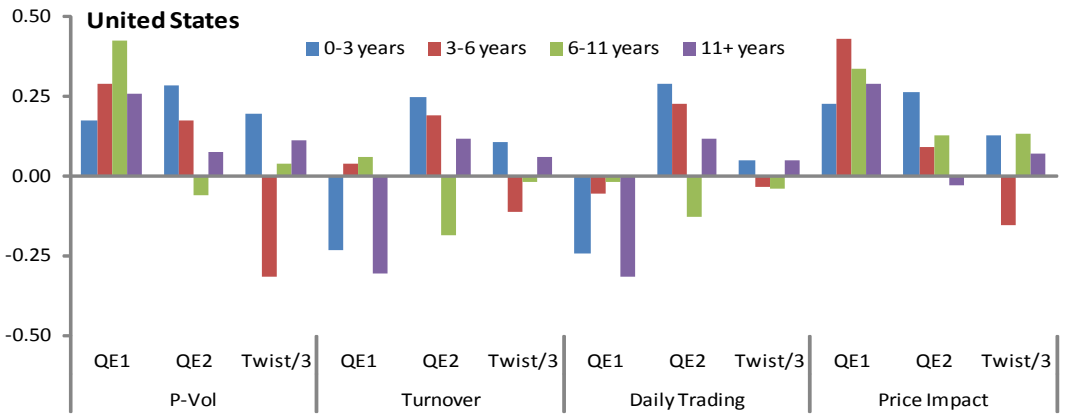


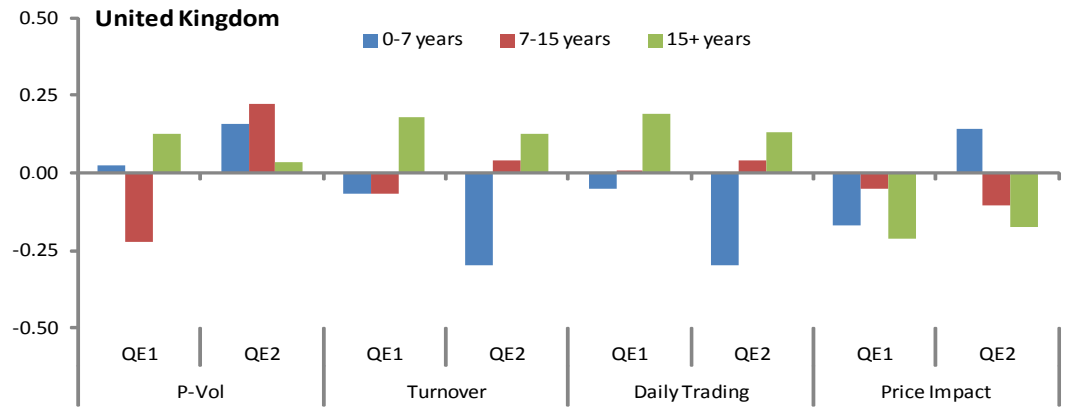
Sources: U.S. Federal Reserve; ECB; JPMorgan Chase; and IMF staff estimates.

- Fed and ECB purchases of MBS and covered bonds reduced yields
- But concerns about market functioning due to large role of central banks in markets

Empirical Findings – Markets

Government Bond Markets:



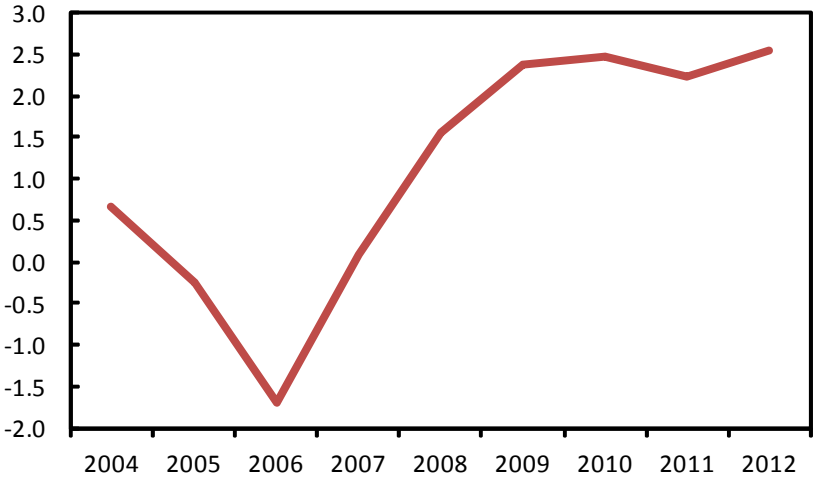


- So far, liquidity and market functioning appear little affected, but risks surrounding exit

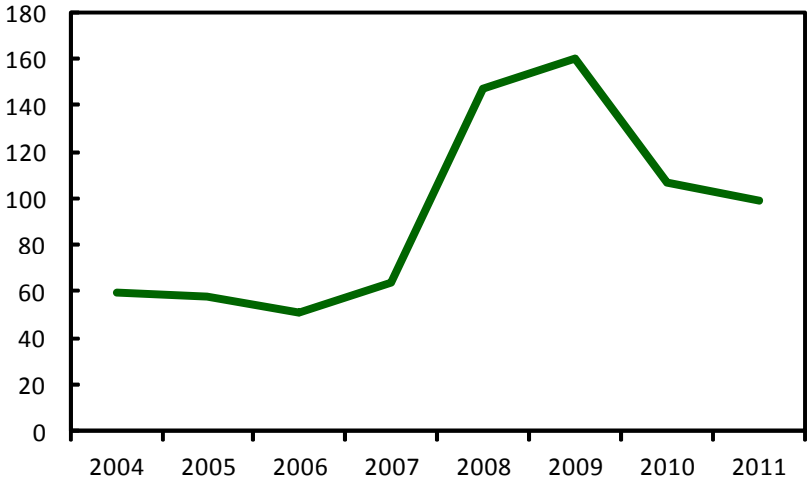
Empirical Findings – Banks
Interest-rate Risk in Banks

- Interest rate risk in banks appears contained…

Effect of a gradual 200-basis-point hike in interest rate on banks' net interest income
(Weighted average, in percent of baseline forecast)



Interest Rate Value-at-Risk
(Weighted average, in millions of U.S. dollars)

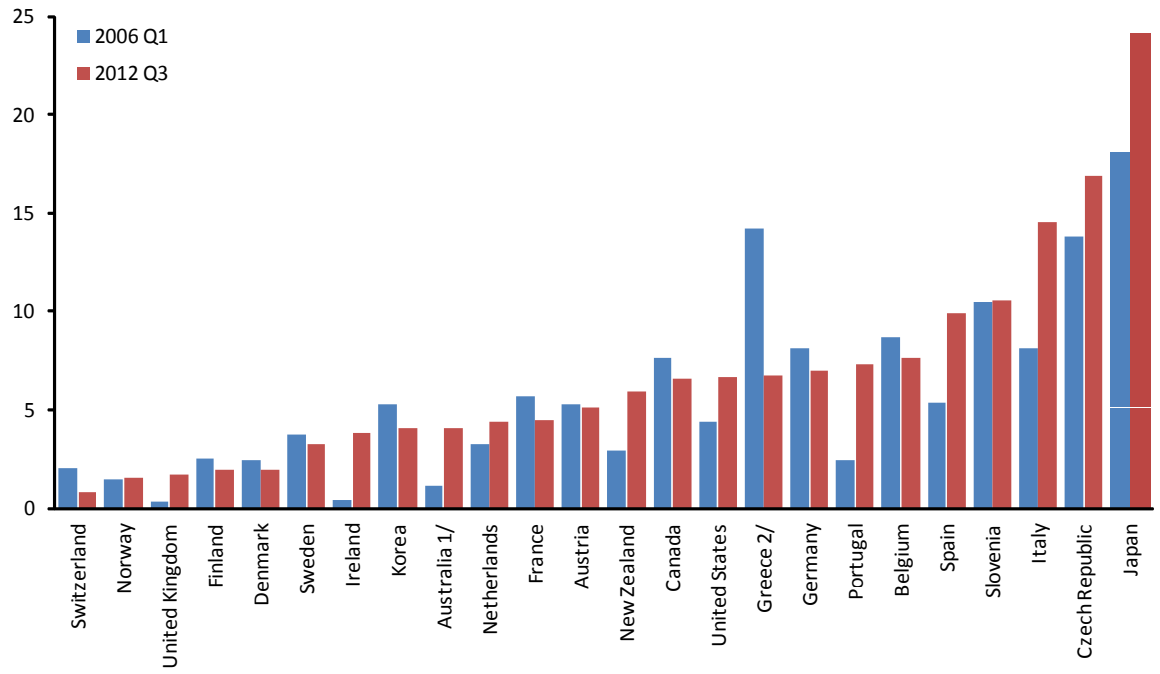


Sources: Bloomberg L.P.; SNL; and IMF staff estimates.

Empirical Findings – Banks
Interest-rate Risk in Banks

- …but banks in some countries face potential capital losses on large holdings of government securities

Bank Holdings of Government Debt in Selected Economies
(In percent of banking sector assets)



Sources: International Financial Statistics (IFS); national regulators and central bank web sites; and IMF staff estimates.

Empirical Findings – Summary

- No evidence of immediate deterioration of financial stability
  - No apparent effect on market functioning
  - Policies have generally improved bank soundness
- But risks are likely to rise the longer unconventional policies remain in place, plus challenges for exit
  - Evidence of increased future default risk with credit quality likely to deteriorate.
  - Large bond holdings by banks in some countries
  - Concerns about other financial intermediaries

Policy Implications

- Policymakers should be alert to possible emerging risks in banks going forward
- Policymakers should be alert to risks shifting to other sectors (shadow banks, pension funds, insurance companies)
- Key is vigorous risk-based supervision, robust data provision

Policy Implications

- Targeted micro-and macroprudential policies would allow greater leeway for unconventional policies to focus on macroeconomic goals
- But limited experience with macroprudential policies, so effectiveness should be monitored…
- … and unconventional policies should continue to keep financial stability in mind

Policy Implications

- Exit from unconventional policies:
  - Avoid missteps in withdrawal from intervened markets
  - Main risk is unexpected or larger-than expected increase in interest rates
  - Exit should be planned carefully and well-communicated

Thank You!

For more information:

IMF Website: www.imf.org
IMF Turkey Website: www.imf.org/Ankara