Seppo Honkapohja: International spillovers from unconventional monetary policy easing and exit – what do we know?

Remarks by Mr Seppo Honkapohja, Member of the Board of the Bank of Finland, in the panel session “Unconventional Monetary Policy and Its Reversal: Policy Options for Growth and Stability”, Asian Economic Panel, Helsinki, 9 June 2014.

* * *

Introduction: the global financial crisis and the crisis in Europe

The start of the global financial crisis can be dated in different ways. One plausible date is almost seven years ago in August 9 in 2007 when significant turmoil in financial markets appeared. This unrest continued and in September 2008 a financial panic brought financial markets to a halt and the resulting economic downturn in 2008–2009 which for a while resembled the pace of developments in the Great Depression.[1] In Europe, a further stage of the crisis appeared in 2010 when a sovereign debt crisis hit some euro area countries. Some of the roots in the Euro crisis were due to specific features of construction of the European Monetary Union, but the crisis was also triggered by the second-wave shocks from the global financial crisis.

The first-round effect of the 2007–2008 panic was a vast deterioration of balance sheets of banks and other financial institutions. Growing uncertainty about asset and collateral quality squeezed credit and dried up liquidity. The downward spiral of the financial system, unseen in developed countries for eight decades, called for prompt and extraordinary policy actions.

Monetary policy responses

Management of short-term interest rates became the key policy tool and the stabilization of inflation the central policy objective during the Great Moderation period. This standard policy framework turned out insufficient to contain the panic. The Federal Funds Rate in the United States hit the zero lower bound in December 2008 and has remained at this level ever since. The European Central Bank also started a series of reductions of its Main Refinancing Operations (MRO) rate.

With little or no room for further interest rate reductions, the central banks in developed countries turned their attention to highly unconventional measures, previously regarded as inconsistent with the inflation targeting paradigm. The objective of these measures was to maintain financial liquidity and stability. However, the move towards longer-term maturities was also designed to flatten the yield curve and stimulate real investment. In November 2008 the Federal Reserve started the first round of quantitative easing and began to buy a wide class of assets, including mortgage-backed securities, long-term government debt and bank debt. By mid-2010 the stock of these assets at the FED reached 2.1 trillion dollars. In the second round, it bought another 600 bln USD. Similar non-standard measures have been taken by the Bank of England and Bank of Japan.

The unconventional measures of the ECB in response to the crisis have been somewhat different. ECB’s tools focused on supporting liquidity and funding for the banking system. The ECB introduced the fixed rate and full allotment principle to all refinancing operations in October 2008. It extended collateral eligibility to less liquid assets. Between 2009 and 2011, the Longer-Term Refinancing Operations (LTROs) were extended to maturities of up to

---

[1] Rajan, R. (2013), A step in the dark: unconventional monetary policy after the crisis. Andrew Crockett Memorial Lecture, BIS, 23 June 2013.

3 years. The ECB also started a purchase program of covered bonds which are a key source of funding credit for private banks in many Euro area countries.[2]

Most importantly, the ECB did not initiate purchases of government bonds. However, in 2010–2012 the ECB operated the Securities Market Programme (SMP), which amounted to sterilized interventions on public and private bond markets (in practice only public). This was done to to facilitate monetary policy transmission in countries that faced severe sovereign debt problems.

The culmination of the Eurozone crisis in mid-2012 was tamed by the creation of the ECB's OMT (Outright Monetary Transactions) program. I quote President Draghi's promise that "Within [its] mandate, the ECB is ready to do whatever it takes to preserve the euro".[3] OMT is a conditional promise to buy in the secondary market without limit government bonds of selected Euro area countries. OMT has worked and remarkably, there has so far not been any need to activate the program.

International spillovers

Liquidity support operations by central banks at different stages, explicit state guarantees to banks and expansionary policies succeeded in stopping the recession, which changed the course of developments in comparison to the 1930's. These unconventional policy measures were not implemented in a group of economically disconnected islands, but in a globalized world with synchronized financial cycles and few borders for capital.[4] It is therefore important to ask what the consequences of these new forms of monetary policy for other countries are and how strong are the potential spillovers.

One new line of theoretical research points to positive effects of international spillovers.[5] If country-specific shocks have global repercussions and intermediaries in both countries face similar balance sheet constraints (think USA and the Euro area), a policy implemented in one county will help the other one as well. However, if these policies are costly, they may lead to a free-rider problem in which both countries wait for the policy being implemented in the other.

These predictions seem to be confirmed empirically, at least in the US case. The first round of QE seems to have substantially reduced bond yields not only in the US, but also in Germany, Japan and the UK.[6] It also contributed to the weakening of the US dollar, although the impact on net exports is a bit harder to assess.[7]

The evidence for ECB policy spillovers is, on the other hand, much weaker. This may in part be due to the fact that the European Central Bank focused on reducing intra-Euro yields. These operations actually lifted German bond yields as the safe heaven effect subsided and in fact strengthened the Euro. The net sale of Eurozone bonds (i.e. net inflows) was strongly

---

[2] See e.g. Cour-Thimann and Winkler (2013), "The ECB's non-standard monetary policy measures", ECB Working Paper No. 1528, April 2013.

[3] Speech by Mario Draghi, President of the European Central Bank at the Global Investment Conference in London 26 July 2012 (www.ecb.europa.eu/press/key/date/2012/html/sp120726.en.html).

[4] Rey Hélène (2013), "Dilemma not Trilemma. The global financial cycle and monetary policy independence", paper presented at the Jackson Hole Symposium, August 2013.

[5] Dedola L., Karadi P., Lombardo G. (2013), "Global implications of national unconventional policies", Journal of Monetary Economics, No.60, 2013.

[6] Neely Ch. (2013), "Unconventional Monetary Policy Had Large International Effects", Federal Reserve Bank of St. Louis Working Paper 2010–018D, August 2013.

[7] Glick R., Leduc S. (2013), "The Effects of Unconventional and Conventional U.S. Monetary Policy on the Dollar", Federal Reserve Bank of San Francisco Working Paper, 2013–11, May 2013.

reflected in the financial account dynamics and closely co-moved with the exchange rate since the beginning of the crisis.

More generally, however, spillovers seem to be asymmetric, with significant impact of the FED abroad, but not the other way round. For Japan and the UK, the smaller size of these operations may be one explanatory factor.[8]

At the very least, therefore, unconventional policies had marked effects on exchange rates. In the Eurozone, the impact was in the opposite direction than in economies which implemented QE. Currency depreciations of large economies, in turn, clearly recall thoughts about beggar-thy-neighbor policies[9] and procyclical waves of capital flows going abroad.[10]

This leads me to discuss the impact of unconventional policies on emerging economies. It has been widely acknowledged that the low returns on assets in the developed world have substantially increased capital inflows to emerging economies, which offer higher yields. For example, a substantial increase of non-financial corporate debt was observed.[11] Equity prices went up and sovereign yields subsided.[12] The side effect of this demand was real appreciation of these currencies. In fact, the international spillovers of FED's QE seem to affect emerging economies more strongly than advanced ones, or even for the US itself.[13]

The implications of currency depreciation in one country may theoretically have some positive effects as well. In an integrated world negative demand shocks spill over and can create a liquidity trap in both countries.[14] The solution to escape it is to inflate the economy. Done in isolation, this leads to currency depreciation and beggar-thy-neighbor effects. But if both countries inflate, then depreciations cancel out and both economies can get out from the trap.

Appreciation may be a problem for a small open economy facing its own zero lower bound, because the bound makes its own monetary policy less effective.[15] But if the goods that the economy produces are complements of those produced in the U.S. (think of commodities used as input in production), the net effects might be positive.

Tapering

Since September 2012, the FED has been purchasing MBS and treasuries at 85 bln per month. In May 2013 it announced a gradual unwinding of QE3, which was then put off/postponed in September. Eventually, the tapering started in January 2014, and it is currently 45 bln USD per month.

---

8 Rogers J., Scotti Ch., Wright J. (2014), "Evaluating Asset-Market Effects of Unconventional Monetary Policy: A Cross-Country Comparison", International Finance Discussion Papers, Board of Governors of the Federal Reserve System, No. 1101, March 2014.

9 Eichengreen B. (2013), "Currency War or International Policy Coordination?", mimeo, January 2013.

10 Reinhart C. and Reinhart V. (2008), "Capital Flow Bonanzas", NBER Working Paper No. 14321, September 2008.

11 Lo Duca M., Nicoletti G., Vidal Martinez A. (2014), "Global Corporate Bond Issuance. What Role for US Quantitative Easing", ECB Working Paper No. 1649, March 2014.

12 Fratzscher M., Lo Duca M., Straub R. (2013), "On the International Spillovers of US Quantitative Easing", ECB Working Paper No. 1557, June 2013.

13 Chen Q., Filardo A., He D., Zhu F. (2012), "International spillovers of central bank balance sheet policies", BIS Papers No.66, October 2012.

14 Jeanne O. (2009), "The Global Liquidity Trap", mimeo, October 2009.

15 Haberis A., Lipinska A. (2012), "International Policy Spillovers at the Zero Lower Bound", Federal Reserve Board Finance and Economics Discussion Series, 2012–23, April 2012.

The announcement and postponement episode stirred some unease internationally, not least in emerging economies. The economic debate has then focused on whether the tapering will trigger a pull-out of capital from the emerging world and potentially trigger a new wave of turbulence, akin to those from 1990s and 1980s.[16]

Preliminary research suggests that news about tapering did have indeed an impact abroad. Announcements by chairman Bernanke were are associated with larger nominal exchange rate depreciations, stock market contractions as well as increases of credit default swaps.[17] Although the initial impact of these announcements has not been necessarily correlated with the strength of the country's fundamentals, over time the attention of financial markets has turned towards more fragile countries. This includes mainly economies which initially witnessed sharp inflows and real appreciations reflected in large current account deficits.[18] India, South Africa, Turkey, Argentina had to increase interest rates early this year to contain exchange rate slump.

Nevertheless, the currency depreciations have not been a unifying story in the developing world. In fact, according to the January 2014 World Bank report, over 60% of developing countries witnessed appreciation throughout the taper-talk period (April–August 2013).[19] In many emerging countries, e.g. Chile, Malaysia, and Mexico, the depreciations were much more pronounced.

The diversity of responses to tapering across different countries, even those within the same geographic region, suggests that domestic factors are the key in amplifying or absorbing these foreign shocks. One clear aspect is the degree of leverage in the banking sector, which has been on the rise in many Asian countries since early 2000s.[20]

It remains a valid question whether and to what extent can the potential negative effects of tapering be spared. The way of implementing the tapering may play a role per se. There are two aspects of this problem. The first is the degree of commitment to policy announcements.[21] The second is the potential for policy synchronization and cooperation.

The mandate of all major central banks is focused solely on domestic policy objectives. Nevertheless, the interconnectedness of global financial markets means that domestic policy decisions which are harmful abroad may ultimately backfire at home. The financial crisis has proved that the interpretation of the legal mandate can be subject to some interpretation, depending on the severity of circumstances. It can also be noted that international coordination of monetary policies is not without precedent. One example is the Plaza Accord in 1985, a joint intervention to weaken the US dollar. Also, in October 2008 four major central banks cut their key policy rates in a coordinated fashion.

At this junction it is not clear if tapering is going to have clear negative effects in emerging economies. The World Bank documents made negative forecast revisions of GDP growth internationally after May 2013. On the other hand, for financially stable economies, moderate

---

[16] Calvo G., Leiderman L., Reinhart C. (1993), "Capital Inflows and Real Exchange Rate Appreciation in Latin America", International Monetary Fund Staff Papers, 40:1, March 1993.

[17] Aizenman J., Binici M., Hutchison M. (2014), "The Transmission of Federal Reserve Tapering News to Emerging Financial Markets", NBER Working Paper No. 19980, March 2014.

[18] Eichengreen B., Gupta P. (2013), "Tapering Talk. The Impact of Expectations of Reduced Federal Reserve Security Purchases on Emerging Markets", mimeo, December 2013.

[19] World Bank Global Economic Prospects, January 2014.

[20] Forbes K. (2014), "Capital Flow Volatility and Contagion: A Focus on Asia", Reserve Bank of India – Asian Development Bank volume on Managing Capital Flows, forthcoming.

[21] Woodford M., "Methods of Policy Accommodation at the Interest-Rate Lower Bound", paper presented at the Jackson Hole Symposium, August 2012.

depreciations may turn expansionary.[22] Finally, unwinding unconventional monetary policy is ultimately a signal of US recovery and should therefore be interpreted as good news.

Another piece of good news might be that, at the end, the spillover effects of policies like QE seem to work through standard, well understood channels, i.e. through exchange rate movements and interest rate differentials. From this perspective it is hard to say what makes these unconventional policies distinct.[23]

---

[22] Céspedes L., Chang R., Velasco A. (2004), "Balance Sheets and Exchange Rate Policy", American Economic Review, Vol.94, No.4, September 2004.

[23] Chinn M. (2014), "Global Spillovers and Domestic Monetary Policy. The Effects of Conventional and Unconventional Measures", paper prepared for the 12th BIS annual conference "Navigating the great recession: what role for monetary policy?", 20–21 June 2013, Luzern, Switzerland.