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QE, OMT, FG – the impotence of central bankers

- **Reaching the zero bound forced central bankers to come up with new tools**
- **While initially successful, these are subject to diminishing returns**
- **The Fed may combine taper with further guidance – but this erodes the value of FG**

Since policy interest rates hit the zero bound during the Great Recession, central bankers have spent much time and ingenuity coming up with alternative policy tools. Some of these have been quite successful but they are subject to the law of diminishing returns. The risk is that, in attempts to reinforce them, central bankers instead erode their efficiency. Far from strengthening the influence of the monetary authorities, this highlights their impotence.

The Great Recession was in some ways a 'normal' financial crises; and in other ways not. One difference compared with previous crises is that central banks in a number of economies, including the most important ones, saw policy interest rates reach the zero bound (or so close to zero that it is effectively the same thing). The inability to lower policy interest rates further led to a search for other tools. The most prominent among these have been quantitative easing (QE), Outright Monetary Transactions (OMT) and the latest fashion in monetary policy, forward guidance (FG).

All of them have initially been successful – perhaps the most successful one paradoxically being the OMT, where success rests on it never being tried. With both QE and FG, however, the efficiency is subject to the law of diminishing returns. Moreover, there are unintended consequences. In a previous Comment (*QE3, OMT => The impotence of central banks*, 14th September 2012), I wrote "One day the Fed will withdraw its monetary policy easing, one day the ECB will cease the OMT. Are markets then not likely to overreact the other way, prompting calls for a bond market 'Draghi/Bernanke put'?"

This is of course exactly what we have seen in the United States over the summer. It is what we most likely will see in the UK if – as seems quite possible – British unemployment drops below the Bank of England's recently formulated 7% target sooner than expected. Should this happen, it won't be necessary for the BoE to talk about raising interest rates; markets will be nervous enough about the prospect and there will be calls for further clarifications on future monetary policy. In fact, that is likely to start well before, once the rate of unemployment gets closer to 7%.

But each time the concept of forward guidance is expanded and clarified, it loses some of its power. This is partly because each clarification, each new threshold, introduces further risks of incompatible targets and targets that may be met at different times, causing more confusion than clarification. Second, changing the goal posts, however well intended, is in itself confusing. And, third, because the each new goal will have to be hedged in with further clarifications, *de facto* making it more and more meaningless.

This is to some extent already the case with the Bank of England's forward guidance. The BoE has said that interest rates will remain unchanged until unemployment falls below 7%, something it forecasts will

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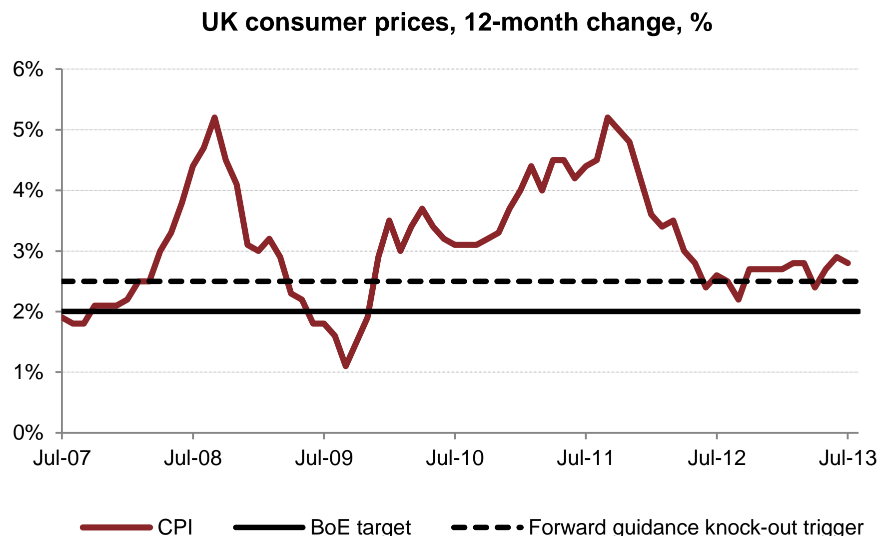
happen by 2016. That is clear and straightforward enough. But then come the caveats, or 'knock-outs' under which the policy may change:

- If the MPC forecasts that inflation will be 0.5 percentage points or more above the 2% target over an 18-24 month time horizon;
- If medium-term inflation expectations are no longer sufficiently well-anchored; and
- If the Financial Policy Committee – the MPC's sister committee, which monitors potential systemic risks – judges that the monetary policy poses a significant threat to financial stability.

The first of these can be disregarded. The MPC has never forecast inflation to be above 2.5% over the relevant time horizon. This is in spite of the fact that inflation has been over 2.5% for most of the post-crisis period.



The second knock-out is tied in with the first and is also unlikely to trigger a change in policy, unless markets reach the conclusion that the MPC is deliberately trying to engineer higher inflation. Given the current elevated rate of UK inflation, that is highly unlikely.

By contrast, the third knock-out is so vague that it can be used to justify any change in policy. Recent UK data has been stronger than expected, raising the possibility of 7% unemployment being reached earlier than expected. Certainly, markets are already assuming that stronger growth could mean that the unemployment target is reached before 2016. Admittedly, the BoE has made it clear that 7% unemployment is not necessarily a trigger for higher interest rates; merely a time to take stock of policy. But markets, probably rightly, are nevertheless seeing it as a sign that interest rates will rise when it is reached.

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The Fed has fewer thresholds – unemployment at 6½%, subject to inflation being below 2% and inflation expectations remain subdued and again no automatic action. But the Fed's communications troubles over the summer have, if anything, shown that no amount of explanation and attempts to prepare markets help when markets have decided that any news is bad news. (In other words, that bad news is bad for the economy; but good news is also bad because it means that monetary policy will be less easy. A similar but opposite effect occurs when markets decide that all news is good news.)

Markets want further 'hard' clarity. They may get it in the autumn. On balance, it is still most likely that the Fed will announce the beginning of its QE taper in September or possibly in October, subject to data. Markets are likely to remain prone to nervousness and desirous of reassurance. There have already been rumours (see *If the Fed threshold changes*, 29th July 2013) that the Fed may lower its unemployment threshold from 6½% to 6%. A possible move would be to announce the beginning of the tapering of QE; to lower the unemployment threshold; and to introduce an inflation floor (perhaps 1.8% for the core PCE deflator, currently at 1.2%) below which interest rates would not rise. There is a question about how this would fit in with the change at the helm of the Fed, but, presumably and depending on who the new Chair will be, that can be overcome.

However, such a shift, if indeed implemented, actually highlights the decreasing power of forward guidance – its impotence. The point about forward guidance is to boost activity and asset prices through calming markets and others and making it clear when the central bank will or won't act. If FG constantly needs to be refined further, complicating what by its very nature works best when it is clear and straightforward, then it is clear that its power is diminishing. It is in any case doubtful how much FG can be used as to forecast monetary policy except in the very short term. A study by the St Louis Fed from December last year concludes "We find that forward guidance improved market participants' ability to forecast short-term rates over relatively short forecasting horizons, but only for Norway and Sweden. Importantly, there is no evidence that forward guidance has increased the efficacy of monetary policy for New Zealand, the country with longest history of forward guidance."[1]

Both QE and FG have initially been successful. Certainly, quantitative easing has played a major part in the US recovery by boosting the growth of broad money, which has been growing at more than 6% in the most recent three months. But, as noted above, both policies are subject to diminishing returns. More importantly, both policies suffer from one significant flaw, namely that markets will really never like a tightening of monetary policy. From that perspective, perhaps the best thing to do would be to spell out – once – thresholds for possible action, hedge them about slightly – and this is of course what both the Fed and the BoE have done – and then, when deemed necessary, start to normalise interest rates, essentially telling markets, 'the economy is on a self-sustaining path, we need to raise interest rates, get over it'.

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[1] Clemens J.M. Kool and Daniel L. Thornton, How Effective Is Central bank Forward Guidance, Federal Reserve Bank of St Louis, Working Paper 2012-063A, December 2012

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