Free exchange

Staying unconventional

New research suggests central bankers should be bolder and more innovative

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AFTER half a decade of bucking convention, the Federal Reserve is settling into more familiar routines. The central bank announced on March 19th that monthly bond purchases under its quantitative easing (QE) programme will be cut by $10 billion to $55 billion, starting in April. For many in the staid world of central banking it will be a relief: QE and other “unconventional” polices used when interest rates hit rock bottom in December 2008 have always been controversial. Yet a new set of papers released on March 20th at the Brookings Institution, a think-tank (and now home to the Federal Reserve’s previous chairman, Ben Bernanke), give a different view. Taken together, they suggest a return to monetary normality may be coming too soon.

Jitters about market bubbles are one reason the Federal Reserve is dialling down its bond buying. A new study by Gabriel Chodorow-Reich of Harvard University shows that since 2013 Federal Reserve committee members, including Mr Bernanke, have cited concerns over increased financial-sector risk-taking as a reason to mute QE. Their anxiety is understandable: central bankers are still scarred by the lessons of the mid-2000s when banks “searched for yield” amid low interest rates, financing riskier projects and pumping up leverage to improve profits. After five years of shedding risk since the crisis that followed, some fret they could flip back into risk-seeking mode.

But those worries wither under closer scrutiny, as Mr Chodorow-Reich shows. He starts his hunt for a link between QE and risk with banks and life insurers, examining market reactions to 14 Federal Reserve policy announcements between 2008 and 2013. Using minute-by-minute data, and isolating small windows either side of each statement, Mr Chodorow-Reich measures market perceptions of risk. He finds that QE extensions are associated with a drop in the costs of default insurance that protects against a bank or insurer going bust. Markets, then, are not worried about QE, even if the central bank is.

Money-market funds (MMFs) are another worry. These firms collect deposits, investing the cash in short-term liquid assets such as Treasury bills. But the returns on these assets tend to track central-bank rates—they are so low that the MMFs’ service charges might outweigh their customers’
gain. The concern is that MMFs might switch into riskier assets to lift returns and justify their fees. But an examination of over 500 MMFs shows they are taking a safer option, cutting their fees rather than increasing risk in an effort to maintain them. An analysis of balance-sheet data of over 4,000 pension funds concurs: despite extended QE and low interest rates, there is no sign of a dangerous search for yield.

And bold monetary policy has a big upside, suggests a new paper on Japan’s “Abenomics” by Joshua Hausman of the University of Michigan and Johannes Wieland of the University of California, San Diego. Japan’s monetary boost is huge, including a new 2% inflation target, unlimited asset purchases and a doubling of the money supply. Many worried, however, that it would not work. Japan’s slump is decades old and QE had already been tried. Between 2001 and 2006 the Bank of Japan boosted the cash that lenders held from ¥5 trillion ($46 billion) to almost ¥35 trillion using QE. Yet not much happened. Although inflation nudged above zero, policymakers increased rates too soon. By the time Shinzo Abe took office in December 2012 prices were falling by 0.1% a year and the economy was drifting sideways.

But Abenomics has lifted Japan’s GDP by up to 1.7%, according to Messrs Hausman and Wieland: up to a percentage point of that may be due to monetary policy. The market effects are clear: stock indices jumped and the exchange rate depreciated sharply when the policy was announced (see left-hand chart). The effects on broad money, which rises with bank lending, have been much stronger than with previous QE attempts (see right-hand chart).

Inflation expectations explain the difference. Abenomics was announced not as a temporary boost but a permanent change in policy. People quickly anticipated that prices would begin rising by 2% a year, instead of remaining flat. Long-run inflation predictions have risen too. This means borrowing looks more manageable and gives shoppers confidence to spend more. Nonetheless, Japan’s economy remains weak. Reinforcing the commitment to monetary boldness would give it a boost, the researchers say.

Moving the target

There are even more radical options. Kevin Sheedy of the London School of Economics reckons that gains may be made from replacing an inflation target with a nominal-GDP (NGDP) target. Typically central banks focus on inflation as this helps stabilise the value of pay, which might otherwise be eroded by rising prices. But wages are not the only rigid
contracts workers face—their debts are fixed too. This means that a GDP shock which lowers incomes can cause a big jump in their debt burden.

A central bank focused on NGDP would help, Mr Sheedy argues. Take a supply shock, which tends to lower GDP without causing prices to fall. A central bank focused on prices might not respond at all due to the absence of inflation. An NGDP targeter would be bolder, stimulating the economy to generate inflation and keep the value of debt and GDP aligned. Hard-wiring a shift like this into the monetary system will take a lot of persuasion. But household debt-to-income ratios were much lower when inflation targeting was set up in the early 1990s. In today’s high-debt world, an NGDP target looks more attractive.

How influential these studies will be remains to be seen. With central banks so far from “normal” monetary policy, new academic insights have recently tended to have a bigger impact than in more ordinary times. And this trio of papers—by quelling fears over QE’s downsides, praising Japan’s monetary expansion and providing new arguments in favour of targeting nominal GDP—make a clear case for bold thinking and big action. Conservative central bankers, take note.


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