Central Banks and Their Policy Tools

During the past decade and a half, the central banks in Europe and the US were able to use the official interest rate to stimulate or dampen their economies. The increase or reduction in interest rates would ripple through the bond markets and the banking system in a predictable manner, bringing about the desired economic outcomes. Following the 2008 financial crisis and economic recession, the central banks lowered their rates to near zero and, since then, the monetary policy makers have relied on "unconventional" measures.

The US Federal Reserve (the Fed) and the Bank of England have been buying various financial assets including government bonds, pools of household mortgages, and corporate debt. The asset purchases target the cost of borrowing, by reducing yields on assets and hence cutting the cost of finance across the economy. A second tool targets interest rates that the public expects in the future. In 2008, the Fed announced that its low interest rate policy would be in place "for some time". In 2012, it went still further, announcing that it will keep rates low until unemployment falls below 6.5%. The idea behind such "forward guidance" is that anyone considering a loan needs to take into account both the interest rates today and likely rates in the future. With credible commitment by central banks to keep future rates low, the expected payment on floating rate mortgages and car loans will drop. Therefore consumption and investment will expand.

However these tools have their problems. Although central banks in the US, Japan, and the Euro Area have large balance sheets, there are other investors who have more influence in the financial markets than the central banks. For example, China and Japan hold more US debt than the Fed. Foreign purchases and sales could thus influence market rates and inhibit the impact of domestic monetary policy. When the Fed lifted its official rate around 2007-2008, yields on government bonds and mortgages did not rise by much. Moreover, throughout 2013, foreign investors sold $45 billion worth of US Treasury bills, nudging up the rates when the Fed would prefer to keep them down.

In addition to the challenge of managing asset purchases, it is also difficult to manage expectations. This challenge is explained in the context of the "time consistency" problem. The issue is that commitment about what the central bankers will do in the future lacks credibility if the public thinks that the monetary policy makers may renege on their promises. The public is well aware that the Bank of England has left itself a lot of room to increase rates if circumstances change: hollow promises to keep the rates low will not affect the expectations of consumers and investors. Both the US and Britain need to sharpen their policy tools. Stronger commitment would help, allowing the central banks to use their reputation to overcome the time consistency problem. They should make an unconditional commitment to keep rates low until some objective threshold – for example a specific unemployment rate—is reached.

Undoubtedly, the policy makers would strengthen their influence if they used the two new tools together, combining asset purchases with strong forward guidance. A 2013 study by the Federal Reserve Bank of San Francisco found that the Fed asset purchases in 2011-2012 accompanied by forward guidance added 10-13% to GDP. Without the promise that rates would be held low, the second round of quantitative easing would have lost two thirds of its potential impact, barely adding 0.04% to GDP; in fact, a mix of lower rates today with the expectation of higher rates in the future will dampen the expansionary effect of asset purchases. Central banks are facing new challenges, but they can use the instruments at their disposal to influence economic outcomes in the direction they desire.

Question: *What does the article consider as policy challenges and solutions for Central Banks? Elaborate.*

Excellent/Good answer: Grade 5-6 out of 6

In the past the Fed and the Central Banks in Europe were able to use a single tool of monetary policy effectively: lowering interest rates to boost the level of economic activity, or increasing them to keep activity in check. However, two related forces have changed the equation. One is the increased muscle of foreign investors to influence interest rates in the U.S. and Europe, and the other is the advent of the 2008 financial crisis followed by the Great Recession.

By and large foreign investors are able to change the rate of interest in U.S. and Europe, rendering the monetary policy by the Central Banks less effective than otherwise. Prior to 2008, the intended higher rates by the Fed did not materialize due to large asset purchases by foreign investors. And during 2013, the large sale of U.S. assets by foreign investors increased interest rates when the Fed's desire was to keep them low.

The financial crisis of 2008 has prompted the Fed and the Central Bank of England to purchase a variety of assets including household mortgages and corporate bonds. The intended effect is to keep the cost of borrowing low and hence expand the level of investment and economic activity. In addition, the Central Banks in U.S. and England have announced that they will keep interest rates low for some time in the future. The intention here is to manage public's expectations of the future interest rates. Low rates in the future keep the expected adjustable mortgage rates and car loan rates low and help spur consumption and investment.

However, monetary policy does face a hurdle: the "consistency problem" and the credibility of the central bank! If the public doubts that the central bank will keep its word about maintaining low interest rates in to the future, the promise by the central bank will not act as an effective "forward guidance" policy tool.

Therefore as the article mentions, the central banks need to sharpen their commitment and produce objective goals-- rather than vague statements-- in support of their forward guidance monetary policy.

Adequate/Fair: Grade 3-4 out of 6

The single tool of reducing or increasing interest rates used to be a sufficient form of monetary policy to expand the level of economic activity or contract it. Since the 2008 financial crisis, Central Banks in U.S. and Europe have sought to purchase other assets besides government Treasuries in order to keep the cost of finance low. They have purchased corporate bonds and household mortgages as well as government debt.

Additionally, the central banks have also used forward guidance by announcing that they will keep interest rates low in the future. This will likely have an added economic benefit by keeping expected rates on home mortgages, car loans, etc. low thereby stimulating the purchases of these items and hence expanding the level of economic activity.

However, foreign investors have more influence than the Fed and Central Bank in Europe. In the last few years, foreign purchases of government Treasuries in U.S. have kept the interest rate slow even though the Fed wanted to maintain it high. Or, they sold U.S. assets and increased the rate when the Fed wants them low.

The Fed and the Bank of England have an additional problem of managing expectations. This is the time consistency problem. This means that the public may not believe that central bankers will keep their promises. Therefore the policy is not credible and so it is not successful. Research in 2013 by the Federal Reserve Bank of San Francisco shows that without the forward guidance—credible promise to keep rate low in the future—the Fed's policy would have been much less successful.

The monetary policy is now more complex than before, however, a mix of asset purchases with the policy of forward guidance will result in increased level of economic activity.

Inadequate: Grade 1-2 out of 6

The Central Bank use monetary policy to make economy better. Their policy is lowering or increasing interest rates which helps the bond market and the banking system.

After the 2008 financial crisis, the central bans purchase household debt and corporate bonds and debt. They announce they keep rate low for some time in future. Therefore the payment on mortgages and cars drop. And therefore consumption and investment also drop.

Also foreign investors have influence and foreigners purchase or sell assets. The Fed increased its rates by 2008 but the mortgage rates did not go up. Then in 2013 foreigners sold Treasuries and the Fed kept the rates low.

The fed has difficulty to manage expectations. In the time consistency problem the public lacks the Central Bank credibility. Therefore the Fed promises to keep rates low and the rates go up. This is not successful.

Both U.S. and Britain should be more careful and use sharp policy tools. A study finds that using forward guidance policy and purchase of assets with lower rates now and expected higher rates in the future is useful.