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Unconventional Monetary Policy

In recent decades, central banks in advanced economies have typically used interest rates as their tool for conducting monetary policy. In response to the global financial crisis (GFC) of 2007–2009 and the deep recession it caused in parts of the world, central banks in many advanced economies lowered their policy interest rates to near-zero levels. As economic growth remained weak, interest rates persisted at near-zero levels and some central banks used 'unconventional' monetary policy to stimulate economic activity. (See Explainer: The Global Financial Crisis and the Deputy Governor's speech Lessons and Questions from the GFC for an explanation of the causes and consequences of the GFC.) These unconventional measures have again become prominent as central banks around the world respond to the severe economic consequences of the coronavirus (COVID-19) global pandemic.

This Explainer describes the difference between conventional and unconventional monetary policy. It also describes the different tools that have been used by central banks when conducting unconventional monetary policy, and summarises those tools that have been introduced more recently in Australia.

What is conventional monetary policy?

Conventional monetary policy has involved central banks changing a short-term interest rate – their policy interest rate – to achieve their economic objectives. The policy interest rate influences other interest rates in the economy (such as interest rates for housing loans or business loans, and interest rates on savings accounts). Changes in these interest rates influence people's decisions to invest or consume, which ultimately affects economic activity. Consequently, by changing interest rates, conventional monetary policy helps a central bank achieve its goals for such things as aggregate demand, employment and inflation. Raising interest rates dampens growth in aggregate demand and employment and puts downward pressure on inflation. In contrast, lowering interest rates stimulates growth in aggregate demand and employment and puts upward pressure on inflation.

In Australia, the policy interest rate used for conventional monetary policy is the 'cash rate', with the Reserve Bank changing the cash rate to influence aggregate demand in a manner that is consistent with its inflation target and efforts to maintain full employment. (For more information in an Australian context see Explainer: What is Monetary Policy? and Explainer: The Transmission of Monetary Policy.)

What is unconventional monetary policy?

Unconventional monetary policy occurs when tools other than changing a policy interest rate are used. These tools include:

- negative interest rates
- extended liquidity operations
- asset purchases (quantitative easing)
- forward guidance.

With the exception of negative interest rates, these tools have always been in the 'toolkit' of

central banks and have been used in some way in the past, particularly to support the functioning of financial markets or governments' financing needs.[1] What has been unconventional in recent years is the use of these tools as the principal mechanism for achieving monetary policy goals.

Negative interest rates

Negative interest rates are truly unconventional. They are also difficult to imagine, as they imply that instead of earning interest on money deposited in a bank, people would be charged by their bank to deposit money. Prior to the GFC, it was widely thought that there was a 'zero lower bound' for the policy interest rate, meaning that it was thought interest rates could never be negative. This was because if interest rates were negative, people would simply choose to hold their savings as banknotes outside the banking system ('cash under the mattress') so that deposits would be unavailable to banks for lending or other purposes.

As it turned out, a zero lower bound did not prove to be a constraint. Policy interest rates were negative in the euro area, in Denmark, Sweden and Switzerland (with the lowest rate being –0.75 per cent in Switzerland). However, commercial banks did not pass on negative policy interest rates and implement negative rates for all their customers – they judged that it did not make sense either commercially or politically to charge households and smaller businesses for holding their deposits (and consequently there was little movement toward people holding their savings as banknotes).[2] Nonetheless, there is still likely to be a lower bound. At some point depositors will withdraw money and hold banknotes, so central bankers began to talk about an 'effective lower bound' for policy interest rates rather than a zero lower bound.

Extended liquidity operations

In response to the GFC, many central banks made significant changes to their existing market operations to deal with strains in financial markets that had become 'illiquid' (i.e. assets could not easily be converted to cash). While the details differed between countries, the changes to operations have included central banks:

- providing much larger amounts of liquidity to the financial system than before the GFC
- expanding the range of collateral that they accept from financial institutions
- increasing the range of 'eligible counterparties' who they allow to engage in domestic market operations
- providing funding to banks at rates below the cost that was prevailing in highly stressed markets.

The purpose of these changes to market operations was to address the fact that in periods of financial stress (during the GFC and in subsequent years), financial institutions were very nervous about their access to liquidity. This, in turn, made them nervous about investing and lending, increasing the likelihood of a severe 'credit crunch' and economic contraction. By providing financial institutions with greater confidence about their own access to liquidity, central banks have been able to support the supply of credit to the economy. Extended liquidity operations have again been used to provide additional liquidity to financial markets in response to COVID-19.

1 Negative rates are, however, not unprecedented. In the early 1970s the Swiss National Bank required banks to levy a –2 per cent rate on non-residents' Swiss franc accounts

2 The policy interest rate was also negative in Japan but this rate was only –0.1 per cent. It applied to a very small share of bank reserves held at the Bank of Japan with negligible flow through to depositor rates faced by households and businesses.

Asset purchases (quantitative easing)

Asset purchases – also known as quantitative easing (QE) – involves the outright purchase of assets by the central bank from the private sector with the central bank paying for these assets by creating 'central bank reserves'.

(This has been popularly referred to as 'printing money'.) Asset purchases have long been a feature of central bank operations (and were once the main tool for influencing the policy interest rate). However, since the GFC, asset purchases have been on an unprecedented scale and led to a very large expansion of central bank balance sheets. Furthermore, as part of their asset purchase programs, central banks have bought a wide range of assets from the private sector (whereas in the past, they bought only government securities), though the main asset type has remained government securities.

The precise goal of asset purchases by the central bank has varied across countries, but a common theme has been the desire to lower interest rates on risk-free assets (such as government securities) across different terms to maturity of those assets. In this way, asset purchases can lower a range of interest rates other than the policy interest rate (which may already be as low as it can practically go – i.e. be at its effective lower bound). Asset purchases also reinforce market expectations that policy interest rates are going to stay low for a long time, with this signaling channel adding to downward pressure on bond yields, especially longer-term yields.

Typically, when a central bank undertakes asset purchases, it can either set a target for the quantity of assets it will purchase (at any price) or a target for the price of an asset (purchasing whatever quantity of assets will achieve that price), whereby the price of an asset is equivalent to its interest rate.

Forward guidance

Forward guidance relates to the communication of the stance of monetary policy. Forward guidance can be:

- calendar-based; or
- based on the state of the economy.

Under 'calendar-based guidance', the central bank makes an explicit commitment not to increase interest rates until a certain point in time. Under 'state-based guidance', the central bank says that it will not increase interest rates until specific economic conditions are met.

A primary motivation of forward guidance is to reinforce the central bank's commitment to low interest rates, which may help push longer-term rates down. A related motivation is to make clear how the central bank can be expected to react in unusual times. Generally, forward guidance has been helpful in reducing uncertainty about the economic and financial outlook.

Unconventional monetary policy in Australia

While the GFC had motivated the introduction of unconventional monetary policies in various countries, Australia was less affected than other advanced economies; it was able to deal with that crisis by using conventional monetary policy as its principal tool and providing adequate liquidity to the financial system – that is, it conducted conventional monetary policy. However, the emergence of the COVID-19 pandemic became an economic event of extraordinary scale across the world. In response to the economic effects of COVID-19, in March 2020, the Reserve Bank implemented unconventional monetary policy measures in Australia, joining central banks in other advanced economies. (See the statement and speech by the Governor.)

Unconventional monetary policy in Australia includes some of the tools described in the previous section, while complementing the longstanding approach to setting policy interest rates.

Policy interest rate setting

The cash rate target was reduced to 0.25 percentage points, its lowest ever rate. This motivated an adjustment to the policy interest rate 'corridor' system that had been used for conducting monetary policy in Australia over many years.

Under the corridor system, banks have Exchange Settlement Accounts with the Reserve Bank (to settle daily inter-bank transactions), where they can deposit funds at an interest rate 0.25 percentage points below the cash rate target, or borrow funds at an interest rate 0.25 percentage points above the cash rate target. Consequently, a cash rate target of 0.25 percentage points is the lowest possible rate at which the floor of the corridor does not become negative. Furthermore, at a cash rate target of 0.25 percentage points, those banks wishing to make deposits in their Exchange Settlement Accounts would receive no interest on their Exchange Settlement (ES) balances. Consequently, the Reserve Bank made an adjustment to the corridor so that some interest (of 0.1 percentage points) would be paid on ES balances to alleviate cost pressures in the banking system arising from the historically low cash rate. In other words, this adjustment raised the floor of the corridor; there was no change to arrangements for the top of the corridor. (See Explainer: How the Reserve Bank Implements Monetary Policy for an explanation of the policy interest rate corridor.)

Asset purchases

A program of asset purchases was undertaken to influence the yield curve. In order to do this, the Reserve Bank purchased government securities. It focused on the yield of government securities with a three-year term because, in addition to the cash rate, it is an important interest rate in financial markets that influences other interest rates in the economy.

The Reserve Bank set a target for the yield on three-year government securities to be around 0.25 per cent, the same as the cash rate, so that the program of asset purchases could complement the cash rate setting.[3] The asset purchases also addressed dysfunction that had emerged in financial markets.

Forward guidance

The Reserve Bank engaged in forward guidance, with this being state-based guidance. The Governor stated that the cash rate target would remain at its lowest possible level until progress was made towards full employment and that the Bank was confident that inflation will be sustainably within the 2–3 per cent range. He also explained that this meant Australia was likely to have current policy interest rate settings for an extended period. Furthermore, the Bank's targeting of yields on three-year government securities was consistent with the Board's expectation that the cash rate will remain at its current level for some years, but not forever.

Extended liquidity operations

The Reserve Bank also increased the size of its regular open market operations and extended its liquidity operations to include a term funding facility for the banking system which allows banks (and other authorised deposit-taking institutions) to borrow from the Bank at low cost. Incentives were provided for these lenders to borrow additional

3 The purchases are not made directly from the Government, but from financial institutions that hold these securities in what is called the 'secondary market'.

funds from the Bank if they increased the credit supplied to businesses, in particular small and medium-sized businesses. The low interest rates available through the funding facility are fixed for the term of the lending, consistent with the forward guidance by the Bank that the cash rate is likely to remain at its current level for some time.

Impact of unconventional monetary policy

Overseas, following the GFC, various forms of unconventional monetary policy were successful in ensuring that credit has remained available in stressed financial markets and that uncertainty has been reduced. This has played an important role in supporting financial stability and economic activity, avoiding much deeper recessions than would otherwise have occurred in many advanced economies as a result of the GFC. In that episode of economic history, many measures were required only temporarily and were successfully unwound. COVID-19 has introduced new economic challenges and demanded a larger response from public policy makers.

However, some argue that there are potential side effects of unconventional monetary policy, for example:

- The willingness of central banks to provide liquidity may reduce the incentive of financial institutions to hold adequate buffers, which could make future episodes of financial stress more likely.
- Persistently low interest rates can damage bank profitability and reduce the capacity of banks to lend. They might also allow less productive firms to survive when they would not normally be viable (though this is not relevant in the case of firms that would otherwise operate normally if not for the economic consequences of COVID-19). And persistently low interest rates can fuel asset price growth (e.g. rising prices of houses and shares) despite weak economic growth, so that growth in debt can become unsustainable and increase the risk of financial instability.
- The role of monetary policy and fiscal policy can become blurred, because if the central bank is purchasing large amounts of government securities (i.e. government debt) at zero interest rates, this could be interpreted as government spending (a fiscal activity) that is financed by money creation.
- Political or social tensions can arise if the central bank's asset purchases are seen to disproportionately benefit banks and wealthy people at the expense of the 'person on the street' (despite the evidence that this form of unconventional monetary policy has supported economic growth and employment for the entire community).

Some of these considerations may apply to conventional policy too, so are not necessarily new. More details about unconventional monetary policy and observations about its impact can be found in the Governor's speech Unconventional Monetary Policy: Some Lessons From Overseas.

Decisions to engage in unconventional monetary policy are weighty, and require the central bank to balance the positive effects of such policy on financial stability and economic activity against the possible side effects, many of which can occur over the longer term. Consequently, when unconventional monetary policy was introduced in Australia, the Governor stated that the policy initiatives carried financial and other risks for the Reserve Bank. However, in the context of extraordinary times, implementing unconventional monetary policy has been consistent with the Bank's broad mandate to promote the economic welfare of the people of Australia. It has also been designed to complement other arms of policy – in particular public health and fiscal policy – in addressing the challenges presented by COVID-19.