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# Global Effects of Unorthodox Monetary Policies

**By Desmond Lachman**

*In the aftermath of the Great Recession, major central banks have scrambled to support economic recovery and to avoid deflation through highly accommodative and unorthodox monetary policy stances. Although relatively successful in the short term, these policies have given rise to incipient asset- and credit-market bubbles and to spillover effects on the emerging-market economies, which could threaten the longer-run world economic outlook. Going forward, these central banks need to be very much more mindful than they have been to date of the longer-term unintended consequences of their policy actions.*

Over the past five years, in the aftermath of the Great Recession, the Federal Reserve, European Central Bank (ECB), Bank of Japan (BOJ), and Bank of England (BOE) have pursued unorthodox monetary policies on an unprecedented scale. They have done so in an effort to stabilize their respective countries' financial systems and to both support an economic recovery and to avoid a lapse into negative inflation. This has led to a massive expansion in these central banks' balance sheets and has taken monetary policy into entirely uncharted waters. These effects raise basic concerns as to how these central banks can successfully exit from these policies.

There can be little question that unorthodox monetary policies were successful in stabilizing the major industrialized economies' respective financial systems in the immediate aftermath of the September 2008 Lehman Brothers crisis. It would also seem that these policies have succeeded in providing welcome support to these economies' recoveries by substantially lowering long-term interest rates and by increasing asset prices.

However, they have come with a host of unintended consequences, including incipient asset- and credit-market

bubbles, which both cloud the global economy's longer-run economic outlook and raise questions as to whether the limits of these policies' usefulness are now being reached. They have also had important spillover effects on other economies in general and on the emerging-market economies in particular that now pose a real risk to the global economic outlook.

## **Similarities and Differences in Policies**

Since September 2008, the motivation for the simultaneous pursuit of unorthodox monetary policies in the major industrialized economies has been broadly similar. All of these countries' central banks needed to intervene aggressively in their financial markets to repair the damage the Lehman crisis wrought. In addition, with policy interest rates having reached their zero lower bounds and with unusually weak economic recoveries and very low inflation, these central banks have all felt obliged to resort to policies aimed at stimulating recovery through reducing long-term interest rates and increasing asset prices.

While unorthodox monetary policies have led to a dramatic expansion of all four major central banks' balance sheets, these central banks have implemented their monetary policies in markedly different manners (see figure 1). Underlying these differences have been basic variances in the structure of these countries' financial systems and in the specific problems that these individual central banks have been trying to address. Whereas in the United States and the United Kingdom the preponderance of borrowing takes place in the bond market, in Europe most borrowing is intermediated through the banking system. This explains why quantitative easing (QE) in the United States and United Kingdom has been effected through large-scale bond purchases whereas in Europe QE has been effected mainly through bank lending.

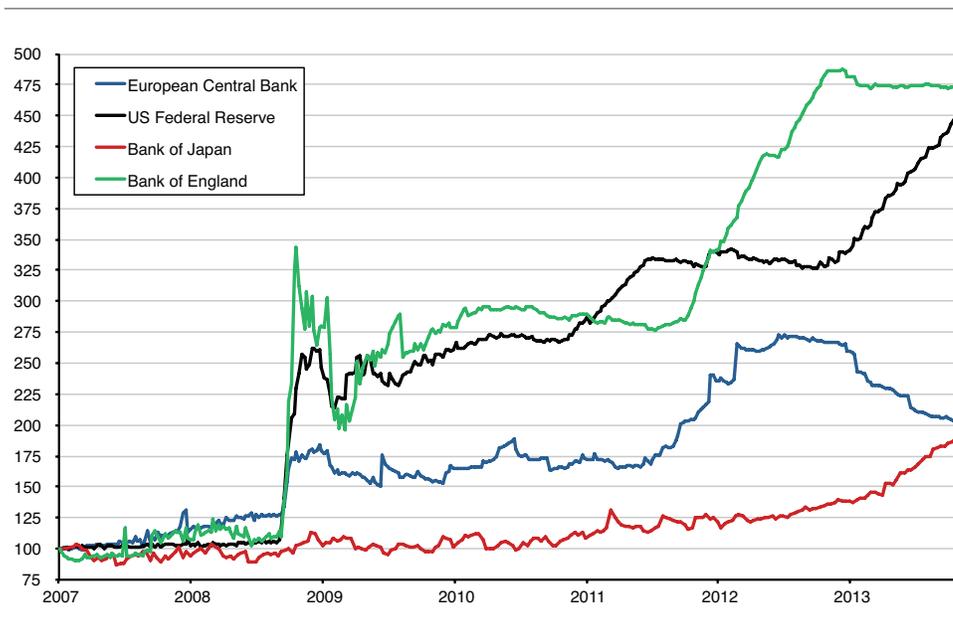
Beyond the common goal of supporting economic recovery, there have also been differences in the specific additional problems that the individual central banks have tried to address. In the United States, the Fed has tried to support the mortgage market through large-scale purchases of mortgage-backed securities; in Europe, the ECB has taken fundamental measures to support the sovereign-debt markets of countries in the European economic periphery; in Japan, the primary objective of the BOJ has been to put an end to years of deflation; and in the United Kingdom, an important objective of the BOE has been to encourage corporate borrowing.

These differences in financial-market structure and in specific objectives are reflected in the present main thrust of the unorthodox monetary policies of the different central banks, which can be summarized as follows.

**The United States.** Since September 2012, the Fed has been engaged in an open-ended third round of QE. This has involved the purchase of US Treasury bonds and mortgage-backed securities at a rate of \$85 billion a month. In addition, the Fed is providing forward

FIGURE 1

**CENTRAL BANK BALANCE SHEETS (2007=100, ADJUSTED BY GDP)**



Sources: Bank of Japan, European Statistical Data Warehouse, Bank of England, and Federal Reserve Board

guidance to the markets by indicating that it will not raise its policy rate so long as unemployment remains above 6.5 percent and inflation expectations remain well anchored.

**Europe.** Since December 2011, the ECB has provided massive support to European banks through its Long-Term Refinancing Operation. This operation provided unlimited three-year financing to European banks against a widened definition of collateral. In addition, since August 2012, the ECB has provided major support to the European sovereign-debt market through its Outright Monetary Transactions program. Under this program, the ECB has offered to buy unlimited amounts of any member country's sovereign bonds with a maturity of up to three years, subject to that country applying to the European Stability Mechanism for an economic adjustment program.

**Japan.** In April 2013, the BOJ introduced a quantitative and qualitative easing (QQME) framework to end deflation and to achieve its 2 percent inflation target within two years. Under QQME, the BOJ aims to double its monetary base by 2014 to around 55 percent of GDP. An important part of the QQME program was the broadening of monetary easing to include long-dated government securities and private-sector risk assets.

**The United Kingdom.** Since January 2009, the BOE has engaged in QE that has involved bond purchases in an amount that has totaled around 25 percent of the country's GDP. In addition, in July 2012, the BOE, together with Her Majesty's Treasury, initiated a Funding for Lending scheme, aimed at reducing funding costs for banks and boosting credit supply.

## Assessing Unorthodox Policies

Assessing the relative success of the unorthodox monetary policies pursued by the major industrialized countries is difficult and subject to debate for two basic reasons. The first is that we cannot know what the counterfactual would have been had these policies not been pursued. The second is that it is still far too early to know what the longer-run consequences of these policies will be since we do not yet know what will happen once these policies are unwound.

Despite these caveats, which will be elaborated upon shortly, there are good reasons to believe that unorthodox monetary policies have had a salutary short-run impact on both the individual economies concerned and the global economy. However, it would also seem that these policies have given rise to unintended consequences and global spillovers, which raise serious concerns about the longer-run global economic outlook and which pose questions as to whether the limits of these policies have been reached.

**Short-Run Success.** In the immediate aftermath of the September 2008 Lehman crisis, central banks in the industrialized countries resorted to a variety of bold and unorthodox measures with a view to restoring the proper functioning of the global financial system. Subsequently, in response to the weakest industrialized-country recovery in the post-World War II period and to very low inflation rates, they resorted to variants of very large-scale QE programs. They did so with a view to restoring aggregate demand by lowering long-term interest rates, by encouraging risk taking, by increasing asset prices, and, although they would be the last to admit it, by cheapening their respective currencies.

There is little room for debate about the major central banks' success in restoring the proper functioning of the global financial system. Through innovative programs such as the Fed's Term Asset-Backed Securities Loan Facility, the US Term Auction Facility and Troubled Asset Relief Program, the ECB's Securities Markets' Program,

and the ECB's Long Term Repurchase Operations, bank access to liquidity was substantially eased. Furthermore, by lending long term without asking too many questions about the collateral they received and by buying assets well beyond their usual limits, the world's major central banks restored liquidity to a world financial system that would otherwise have been insolvent based on prevailing market prices.

There would also seem to be little room for doubt that the world's major central banks succeeded in lowering long-term interest rates and in boosting asset prices. Long-term borrowing costs for the governments and private sectors of the industrialized countries were reduced to post-World War II lows. At the same time, global home prices have recovered appreciably, while global equity prices have risen sharply from their post-Lehman lows to a six-year high.

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## Recent capital flows and currency movements

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Two particular successes of recent central-bank intervention warrant mention. The ECB's Outright Monetary Transaction program, announced in August 2012, succeeded in substantially reducing sovereign borrowing costs in Europe's troubled economic periphery (see figure 2). It did so by removing the tail risk of an imminent eurozone breakup by offering governments in the periphery with a credible backstop. Similarly, the BOJ's more aggressive round of QE announced at the end of 2012 succeeded in substantially weakening the Japanese yen and increasing Japanese inflationary expectations.

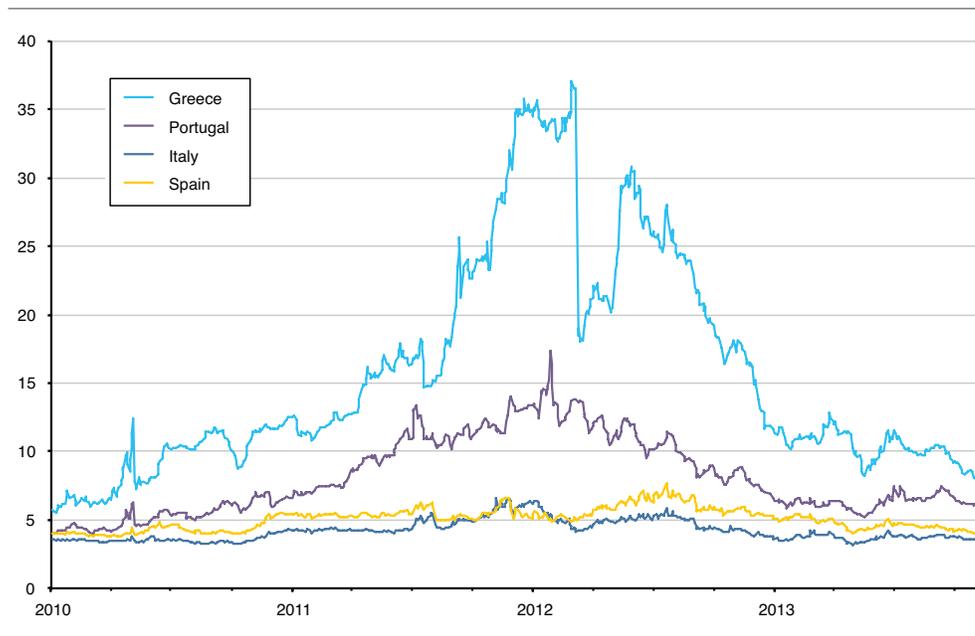
Critics of QE observe that despite the large decline in long-term borrowing rates and the strong increase in global asset prices, the economic recovery in the industrialized countries is the weakest of the post-World War II period (see figure 3). While very likely true, this criticism would not seem to be a serious indictment of recent QE policies. It overlooks the fact that, absent forceful central-bank action, it is highly probable that the industrialized countries would have again lapsed into recession.

**Unintended Consequences.**

A more serious line of criticism of the unorthodox monetary policies being pursued by the world's major central banks is that too little regard is being paid to the unintended consequences flowing from these policies. These consequences could materially compromise the longer-run global economic outlook. Among these unintended consequences are (1) the risk that these policies might be giving rise to excessive risk taking and to bubbles in the asset and credit markets; (2) the large spillovers to other economies through capital flows and exchange-rate movements; (3) the moral hazard that these policies might be causing by reducing the governments' urgency to undertake necessary but painful economic reforms; and (4) the risk that exit from these policies might cause global financial-market dislocations.

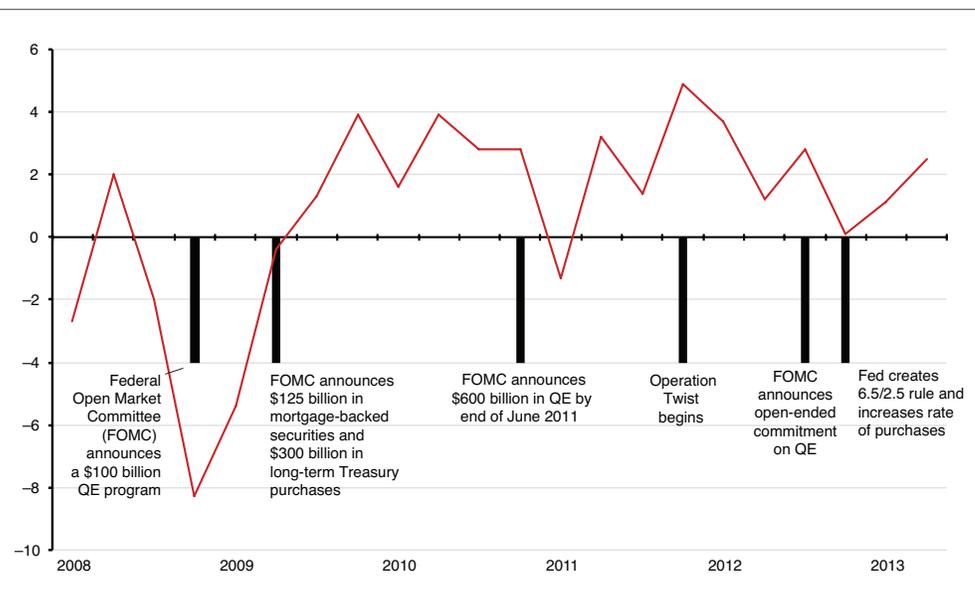
An important aim of the QE policies pursued in the United States, the United Kingdom, and Japan has been to encourage risk taking and to raise asset prices as the means to stimulate aggregate demand. The question that now needs to be asked is whether these policies may have given rise to excessive risk taking, overleveraging, and bubbles in asset and credit markets. In this context, one has to wonder whether historically low yields on junk bonds in the industrialized countries now understate the risk of owning those bonds

FIGURE 2  
EUROZONE 10-YEAR GOVERNMENT BOND YIELDS (PERCENT)



Source: Bloomberg

FIGURE 3  
US QE TIMELINE AND REAL GDP GROWTH  
(QUARTERLY AT AN ANNUAL RATE, Q1 2008–Q1 2013)



Source: Bureau of Economic Analysis

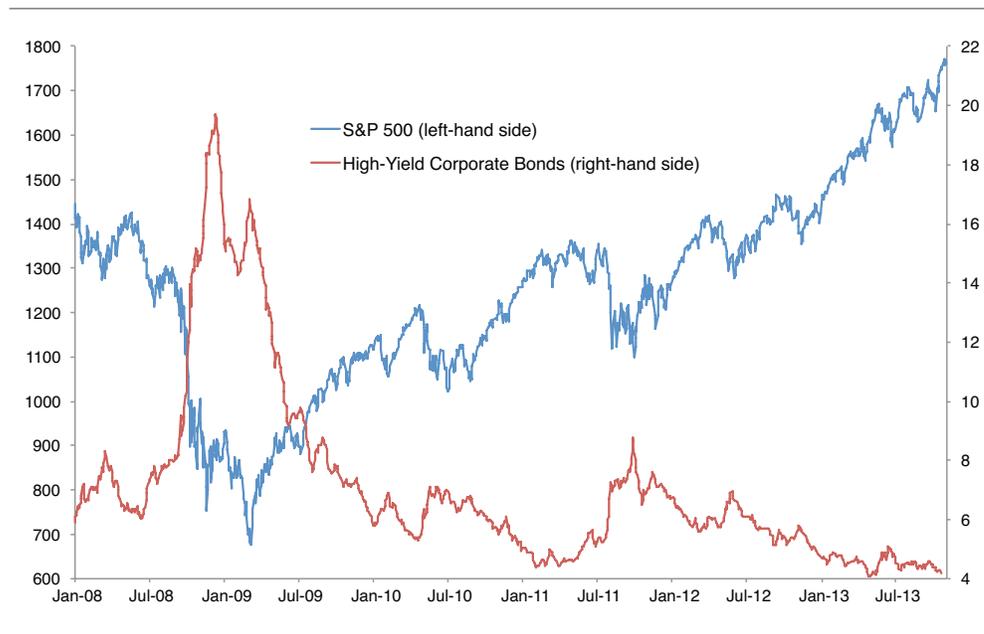
(see figure 4). One also has to wonder whether yields on sovereign bonds in the European periphery have become disassociated from those countries' underlying economic fundamentals and whether global equity valuations have not become excessively rich.

Over the past year, the aggressive Fed and BOJ QE policies have given rise to large-scale capital flows and to significant exchange-rate movements. The Japanese yen has depreciated by around 20 percent since the launch of Abenomics in December 2012, which has given rise to complaints about competitive currency depreciation from countries like China and Korea. Meanwhile, the euro has appreciated by around 10 percent, which is hardly helpful to a European economy that is the worst performing of the major industrialized economies.

Recent capital flows and currency movements have been particularly disruptive to the emerging-market economies, which have been the main engine of global economic growth. These countries have had the greatest difficulties preventing these large capital inflows from causing their currencies to become overvalued and their external current accounts to increase to unsustainable levels. These countries' vulnerability to a change in global liquidity conditions has been all too apparent in the wake of Ben Bernanke's intimation in May 2013 that the Fed might start tapering its bond-purchasing program. That intimation caused sharp currency depreciations in Brazil, India, Indonesia, and South Africa, which prompted the International Monetary Fund to significantly downgrade its economic growth forecast for the emerging-market economies.

Yet another unintended consequence of the unorthodox monetary policies is the moral hazard to which they are giving rise. This is particularly apparent in Europe and Japan. Europe is not using the breathing space in its sovereign-debt market that the ECB's Outright Monetary Transactions program afforded it to move more expeditiously toward the banking and fiscal union that would seem necessary to put the euro on firmer footing. Similarly, the very much more expansionary monetary policy by the BOJ seems to be blunting the Japanese government's urgency to move ahead with structural reform that was supposed to be an important pillar of the Abenomics program.

FIGURE 4  
S&P 500 AND HIGH-YIELD CORPORATE BONDS



Source: Bloomberg

## Conclusion

In the period immediately ahead, the world's major central banks are likely to be confronted with the most difficult of policy choices. A lackluster economic recovery and very low inflation would argue in favor of maintaining or even increasing the present pace of QE. Yet doing so would accentuate these policies' longer-run unintended consequences, which are already so much in evidence.

One has to hope that the world's major central banks strike the right balance between the short-run gains to be obtained from further QE and the longer-run adverse costs of those policies. In particular, one must hope that these banks refrain from repeating their past mistakes of unduly fueling asset- and credit-market bubbles and of contributing to undue exchange-market volatility.

## About the Author

Desmond Lachman, a resident fellow at AEI, was formerly chief emerging-market strategist at Salmon Smith Barney and was deputy director of the International Monetary Fund's Policy Development and Review Department. He has written extensively on the European debt crisis.