CHALLENGES IN IMPLEMENTATION OF UNCONVENTIONAL MONETARY POLICY INSTRUMENTS IN POST CRISIS ENVIRONMENT

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Abstract:

Global financial crisis has led central banks to rethink their monetary policy framework. Nowadays is discussed the possibility of adding unconventional measures to the traditional toolkit of monetary policy. However the main objections rest on still unsolved practical problems which brings the implementation of these measures under normal conditions. And, mainly, they should be integrated into the overall framework of the monetary policy and coordinated with over measures.

The aim of the paper is to set out new approaches to study the challenges implied by the implementation of unconventional monetary policy measures, their inter-relations with traditional tools and their effects on attainment of the strategic goals of monetary policy, in the post crisis environment.

Key words: unconventional instruments, monetary policy, quantitative easing, credit easing.

JEL classification codes: E52, E58, E61

1. Introduction

During the global financial crisis, many central banks both, in developed and developing countries had moved to non-standard measures of monetary policy, due to the following reasons: first, in many developed countries, central banks had exhausted the possibilities of the "standard" tools to stimulate the economy after key interest rates were reduced to almost zero; secondly, appeared the need to address the issues of financial instability, and central banks had taken various measures to address the problems related to the functioning of financial markets.

The global financial crisis has affected to varying degrees the developed and developing countries, which in turn determined the nature of the problems faced by central banks of these groups of countries, as well as the scale of the implementation of non-standard measures of monetary policy. Countries with emerging markets have been forced to deal with problems associated with high inflation and capital flight, which did not allow to carry out a large-scale reduction of interest rates to stimulate the economy in most countries. At the same time, even after the reduction of inflationary pressures, developing countries have not been able to lower interest rates to levels close to zero (in developed countries) due to the higher level of risk inherited in the national assets.

Thus, in developing countries were applied measures of large-scale redemption of assets (quantitative and direct credit mitigation). Countries with emerging markets relied heavily on the indirect credit mitigation measures: central banks have expanded list of counterparties and assets that can participate in transactions with them, provide liquidity to commercial banks for longer than the pre-crisis practice time.

In case of emerging markets, implementation of unconventional monetary policy measures arises a series of issues, related to its correlation with traditional toolkit, and coordination with other macroeconomic policies.

In order to explore the exposed problem, the study was structured as follows: in second section was made a short introduction in theoretical framework of unconventional monetary policy instruments, in third section were explored the main challenges faced by EMEs in implementation of unconventional monetary policy and in the fourth part were provided some recommendations for sustainable implementation of non-standard framework.

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2. Classification of unconventional monetary policy measures used by central banks during the global crisis

The literature provides several classifications of unconventional measures of monetary policy or of policy of balance sheet accounts.

1. Unconventional measures of monetary policy include those measures that increase the size of the balance sheet accounts of business entities, and those that change the structure of their balance sheets. (Bernanke et al. 2004)

2. Alternative measures are divided into: a) measures of quantitative easing, which usually refers to the purchases of long-term securities performed by the Central Bank; b) credit easing measures (Bernanke 2009; Lenza et al. 2010)

3. Alternative measures can be divided into the measures used to maintain financial stability or for macroeconomic stabilization.

But the terms used in these classifications are interpreted by the authors in different ways. Thus, the terms of "quantitative easing" (ie, the purchase of bonds) can be used in the financial analysis to investigate the consequences of liquidity allocation in the secondary market, but can be used also for macroeconomic analysis in context of consequent reduction of long-term interest rates.

Similarly, the term "credit easing" may be used for measures to support financial stability (eg, liquidity allocation for important secondary credit markets) and for direct aid to the borrowers (eg, Central Bank loans for corporations).

4. Types of unconventional measures can be classified according to how relevant transactions are recorded in the balance sheet of the Central Bank;

5. Some experts analyze unconventional measures DCT in terms of the markets in which they are implemented: a) measures of the exchange rate policy; b) policies related to the management of sovereign debt; c) the credit policies; d) measures of bank reserves policy.

3. Challenges faced by EMEs in implementation of unconventional monetary policy

Analysis of non-standard measures undertaken in developing countries during the global crisis is compromised by the fact that in times of crisis, some of the Central Bank only began the transition to the full establishment of a well-functioning framework of monetary policy.

The widespread view at the beginning of the global financial crisis was that the emerging markets should not be affected at large scale. However, after the collapse of investment bank Lehman Brothers, many developing countries have also been affected to varying degrees and consequences.

There are several key features of the implementation of non-standard monetary policy measures in developing countries compared to developed. The central banks of countries with emerging markets relied heavily on credit for mitigation measures, extending the list of assets that can be used in transactions with the central bank, as well as increasing the number of central bank counterparties. Also, central banks in developing countries have increased the maturity of the offered liquidity for commercial banks. Key interest rates in developing countries, remained high compared with developed countries, and did not approach the zero level.

According to the calculations carried out in Ishi et al (2009), for 40 developing countries, the average level of key interest rate was about 6%. Opportunities for developing countries to reduce interest rates were limited by the need to pertain inflation. In addition, relatively high interest rates in EMEs were determined by higher risks inherited in their assets. Therefore, reduction of interest rates did not occur, due to the threat of capital flight from emerging markets.

The higher level of risk of assets from developing countries did not allow central banks to undertake large scale measures for quantitative or credit easing instruments, as the additional liquidity could intensify capital outflows from emerging markets. Therefore, the application of measures of quantitative easing was an exception for countries with emerging markets: Only the

Bank of Israel carried out the redemption of long-term government bonds in 2009 from March to August.

It is also one of the motives for which the central banks in developing countries did not redeemed assets, due to the risk of loosing the confidence in the central bank's policy. Large-scale purchases of government securities by the central bank would be regarded as a loss of their independence and could cause an increase in inflation expectations.

The reduction of interest rates did not happen immediately after the collapse of Lehman Brothers, but only a few months later. It should be noted that for some countries (eg, S. Korea) was an important moment the reciprocal agreement for currency swap with USA which provided a dollar liquidity swap lines. Another feature of the monetary policy in developing countries was the declining rate of reserve requirements in order to increase the amount of liquidity available for commercial bank usage.

Thus, central banks in many developing countries were faced with the need to select the orientation of the monetary policy. On the one hand, the global financial crisis had a significant impact on the prices of assets in developing countries, causing their decline. In addition, there was a depreciation of the national currency and an increase in inflation. Lower interest rates would lead only to further exacerbation of these problems. On the other hand, a decline in economic growth, could serve as an argument for monetary policy easing. At the same time, in developed countries interest rates were declining, increasing spreads between the rates in developed and developing countries.

As a result, countries with emerging markets shifted to lower interest rates at different times, in dependence by how successful was the fight against inflation. For example, Asian countries were able to achieve a faster decrease in the growth rate of the general price level. In other states, such as Latin America, Russia and Indonesia, for a long time, the rate of inflation could not be reduced. Thus, we can conclude that during the acute phase of the global financial crisis in developing countries was more feared the rising inflation expectations, which increased challenges in the financial markets and, as a consequence, the further depreciation of the national currency, which could lead to softening of the monetary policy. Central Bank of this group of countries chose to abandon the lower interest rates. At the same time, to support the financial sector and economic activity, alternative instruments have been used. To the traditional toolkit, lower interest rates, the central banks moved later, first in Asia and then in Latin America and other emerging markets.

Central banks in some developing countries, in response to the worsening of the financial crisis, eased requirements for assets that can be used as collateral during liquidity provision operations. These countries include, in particular, Chile, the Philippines, South Korea and Russia. In addition, many central banks had increased the maturity of liquidity to commercial banks.

In Argentina and the Czech Republic, for participation in repo transactions with the central bank were allowed the guaranteed loans. In Korea in the list of assets that can be used by commercial banks to carry out operations with the central bank, had been included liabilities of commercial banks and bonds of some government agencies. Chile's central bank had started to accept term deposits as collateral for repo transactions. At the same time, the longest maturity for liquidity provided to commercial banks, was extended from 1 day to 180 days.

In many emerging markets, also were changed the parameters for credit instruments of constant action. For example, in Brazil as assets allowed for repo transactions with fixed terms, were accepting credit requirements. The Bank of Mexico after the beginning of the acute phase of the global financial crisis had created a new tool for providing liquidity to commercial banks under the expanded list of assets at a discounted rate.

It should also be noted that in some developing countries, there were no serious problems in the money market, so the central banks did not apply to the corresponding non-standard measures. These countries were Colombia, Malaysia, South Africa and Thailand.

Currently, in many emerging markets many non-standard measures, used during the crisis, are not used any more. However, recently, the central banks of some countries have moved to the implementation of measures of quantitative easing, directed toward stimulation of bank lending. Thus, have become widespread a variety of instruments directed to support lending for small and medium-sized enterprises. In addition, it is worth noting that a variety of programs for supporting

lending to small and medium-sized businesses in some emerging markets were undertaken since the beginning of the 1990s. In fact, these mechanisms that are the part of the operational mechanism of the central bank, meet the definition given by the IMF measures to mitigate the indirect credit easing.

4. Recommendations for implementation of non-standard measures in EMEs

During the global financial crisis, the Central Banks from developed and developing countries gained a great experience in implementation of non-traditional measures of monetary policy, which allowed them to identify the most successful approaches to the realization of non-standard measures and to develop criteria for assessing the most appropriate actions of the central bank during a shock period. Below we provided some recommendations for central banks to ensure an appropriate application of non-standard measures in EMEs.

1. Objectives of unconventional monetary policy measures taken to ensure transparency and accountability of the Central Bank

- Objectives and content of the non-standard measures DCT should be clearly announced and should be related to the objectives of the Central Bank.

- The Central Bank should provide full information on the functioning of the transmission mechanism of the implementation of non-standard measures, as well as specify the risks associated with this policy.

- The Central Bank should announce the operational details of the implementation of non-standard measures of monetary policy, including the terms, conditions and results of the auctions to provide liquidity.

- The Central Bank should report on progress in achieving the objectives for non-standard measures of monetary policy.

2 The coordination of monetary, fiscal policies and financial sector regulation

- Non-traditional monetary policy should be directed towards maintaining financial stability and must be accompanied by measures in the field of financial regulation and supervision, all directed to annihilate the crisis situation.

- Policy of the central bank to change the balance sheet accounts must be clearly separated from fiscal policy.

3 The development of the appropriate framework for unconventional monetary policy measures

- The central bank should have sufficient operational flexibility for implementation of non-standard measures.

- Non-standard measures of monetary policy should be designed in such a way as to minimize disturbance of the functioning of the economy, in particular, the threat of unfair behavior and inefficient resource allocation.

- The strategy of implementation of non-standard measures of monetary policy should be designed in advance and will be announced at the beginning of their implementation.

4 Appropriate control of the risk assumed by the central bank in the process of implementation of non-standard measures of monetary policy

- For each type of operations designed to provide liquidity should be developed the customized tools for risk management (list of assets accepted as collateral, pricing mechanism)

- Private debt securities may be used in operations with the central bank (involving direct or reverse transactions) only under the condition that they have a fairly high investment rating.

- The central bank should have sufficient financial strength and the degree of the risk assumed by the central bank should be discussed with the government (including the need to develop a plan to make resources available to the central bank, if a situation arises in which they will need it.

- The central bank should announce measures to support its financial stability, which can be taken in the event of a loss from the implementation of the quantitative or credit easing.

Conclusions

In order to overcome the consequences of the global financial crisis, many of the Central Bank was forced to look for new tools of monetary policy, which the regime would depend on the socio-economic potential of the country and would be consistent with the level of development of its financial market.

In order to maintain macroeconomic stability in the conditions of financial crisis, many central banks have turned to unconventional measures of monetary policy. These measures include a variety of purchases of bonds (public and private), large-scale foreign exchange intervention and direct lending to the private sector of the Central Bank. The addition of unconventional measures to traditional toolkit should be associated with the identification of problems related to when and how to implement them better. They should be integrated into the overall framework considering the potential failures and cost which they could generate.

In this study we supported the view that non-traditional measures of monetary policy should be used only in special circumstances, in order to restore macroeconomic and/or financial stability when other tools are not effective. It should be a clear distinction between fiscal, monetary and financial policies to avoid excessive pressure put by the government on the Central Bank.

Accumulating on the accounts and deposits of government funds and making private sector dependent on government support, the Central Bank shall take over the often excessive financial risks. Thus, on the one hand, it may lose some of its independence (financial and operational), on the other - to be in the center of a number of potentially serious conflicts of interest (for example, between taxpayers and the owners of financial institutions).

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