

# Central Bank Forays into Unconventional Monetary Policies: Explanation, Assessment, and Implications

By Pierre Siklos

This paper describes the era of unconventional monetary policies (UMP) and its principal motivations and tenets. The principal instruments of UMP are quantitative easing (QE), which encompasses central bank purchases of government-issued bonds, and private sector debt, such as mortgages, as well as forward guidance. The latter encompasses the public statements made by central bank officials that signal the likely direction of future monetary policy.

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Much of the paper's focus is on the activities and experience of the US Federal Reserve, which has been practicing UMP since the financial crisis of 2008-2009. It also examines the Bank of Canada's more limited forays into UMP.

The reliance on UMP by central banks in both countries and in the European Union and Japan pre-empted reliance on changes in central bank policy rates, which was the traditional instrument of monetary policy. Rates of inflation that were persistently below central bank targets as well as policy rates approaching what is known as a zero lower bound motivated central banks to implement new policy instruments.

There has been a great deal of controversy surrounding both QE and forward guidance. Specifically, there is contention about the effectiveness of UMP in counteracting recessionary forces subsequent to the financial crisis, as well as concern that major and sustained QE initiatives contributed to the surge in inflation in 2021-2022.

The paper discusses the challenges that central banks confront in calibrating their monetary policy initiatives. It also reviews available evidence on the effectiveness of unconventional monetary policies with respect to their contribution to macroeconomic stability. The evidence points to a mixed record for UMP. Specifically, UMP likely prevented even worse macroeconomic outcomes following the great financial crisis of 2008 and the subsequent euro area sovereign debt crisis than the world would otherwise have experienced. However, there is also a concern that both extensive QE after the onset of the pandemic and central bank forward guidance signaling that inflation was likely to be transitory exacerbated the inflationary effects of supply chain and related disruptions to production activities.

The effective use of UMP faces significant challenges. In particular, critical indicators that central bankers use to justify continuing to rely on UMP and accompanying ultra-low interest rates rest on unobservable metrics, particularly the neutral real rate of interest. This is the real rate of interest consistent with holding inflation at the central bank's target

rate. Estimates of the unobservable neutral real rate of interest by central banks have declined substantially since the financial crisis, in part reflecting a belief in the phenomenon known as secular stagnation. The theory of secular stagnation holds that weak aggregate demand is the main factor explaining below-trend economic growth and below-target inflation for much of the period following the financial crisis. The secular stagnation phenomenon helped support the view that the neutral rate of interest had declined substantially, and that expansionary monetary policy as manifested in UMP was less likely to cause inflation than had been thought by previous generations of central bankers.

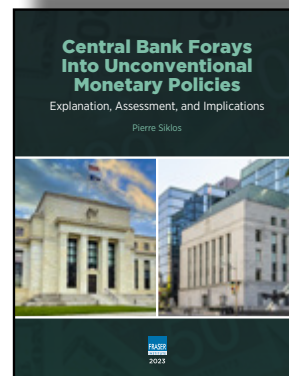
When the combination of fiscal and monetary expansion in response to the pandemic of 2020-22 coincided with increased inflation, central bank credibility was adversely affected. The events of 2021 and 2022 arguably revealed over-confidence on the part of central bank officials that inflation could be kept in check despite warnings to the contrary by at least some prominent economists.

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Scholars can reasonably argue that UMP initiatives were appropriate given the widespread economic shutdowns pursuant to the initial spread of the COVID virus, particularly given the perception of central bankers that they shared

responsibility with the government for preventing a major COVID-related economic downturn. Nevertheless, the accumulated impact of those policies are proving difficult to reverse, which highlights a well-known but largely forgotten rule: monetary policy has its limits. It was arguably too loose for too long and the problem was made worse by overburdening central banks with too many tasks.

While the main near-term focus of monetary policy is to restore price stability, it is not too soon for a rethinking of the primary role and responsibility of central banks as well as the monetary policy strategies appropriate to the central banks' policy focus. Such a rethinking should include whether and how monetary and fiscal policies might be better coordinated and whether a return to relying primarily on the policy interest rate as the main monetary policy tool is advisable.



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