

Discussion of “On the Quantitative Effects of Unconventional Monetary Policies in Small Open Economies”*

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This paper contributes to the expanding literature on unconventional monetary policies. So far, much of the literature has focused on advanced economies. This may be natural because the United States and the European Union are the sources of the current crisis. However, many emerging markets have also been affected by the current crisis, and their central banks have employed unconventional policies. The paper is one of the earliest papers that consider unconventional monetary policies for an emerging economy.

García-Cicco modified the standard small open New Keynesian model by incorporating several frictions that motivate unconventional monetary policy. Those are as follows: the liquidity premium between the money market rate and short-term government bonds, the deviation from uncovered interest rate parity (UIP), and the term premium of long-term government bonds. The deviation from UIP may arise from costly adjustment of international portfolio. The term premium may arise from imperfect substitutability between long- and short-term bonds. It is assumed that policy instruments affect those friction terms directly. An increase in base money decreases the liquidity premium, the provision of foreign reserve affects the UIP condition, and the relative supply of long and short bonds affects the term premium. Even though those are assumed without microfoundations, it seems that those assumptions are reasonable. Financial frictions are estimated using Chilean data, and the estimated coefficients are interpreted as representing policy multipliers.

The paper considers four policy instruments: the money market rate, base money, supply of long and short bonds, and foreign

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reserves. And four types of unconventional monetary policy are considered: purchase of foreign assets by selling money, purchase of domestic bonds by selling money, purchase of long-term bonds by selling short-term bonds, and purchase of foreign assets by selling bonds. The first two are thought to be liquidity provision because supply of money stock increases. The third and fourth change the composition of the central bank balance sheet while keeping its size.

When evaluating those policies, García-Cicco also takes into account the effects of expectations about the future course of policy rate. In the benchmark case, the money market rate is fixed forever. This is similar to the zero interest rate policy. In an extension, he considers the case in which the money market rate is temporarily fixed but afterwards is chosen by a Taylor-type policy rule. In addition to this, he assumes that the date of exit from the fixed interest rate policy is uncertain to private agents. This corresponds to the situation where commitment to the zero interest rate policy is not credible. When he analyzes exit from unconventional monetary policy, he considers anticipated exit as well as unanticipated exit.

The main finding is that the policies that provide liquidity have big effects, while the size of the effects depends crucially on expectations about the future course of the monetary policy rate. On the other hand, credit-easing policies that affect term premiums have smaller effects, but the size depends less on expectations. Finally it is shown that exit policy is contractionary.

García-Cicco makes an early and important contribution to the analysis of unconventional monetary policy for emerging markets. Future work would benefit from considering more explicitly the difference between types of unconventional monetary policy adopted in advanced economies and those in emerging markets. The difference may reflect differences in economic structure, types of shocks, and institutional characteristics. Ishi, Stone, and Yehoue (2009) collect episodes of unconventional monetary policy from thirty-five emerging markets. According to them, those emerging markets adopted unconventional monetary policies under much higher nominal interest rates, in contrast to advanced economies where the nominal rates virtually hit the zero bound. The average nominal rates in emerging markets are 5–9 percent, reflecting both high economic growth rates and high inflation. This implies that the zero lower bound is not

a practical concern for many of those countries. Second, liquidity provision is widely used. This includes both provision of domestic liquidity and provision of foreign exchange. Twenty-eight countries injected domestic liquidity and twenty countries injected international liquidity. Chile injected both domestic and international liquidity. On the other hand, credit easing and quantitative easing have not been implemented.

Given those facts, the analysis of provision of international liquidity as well as domestic liquidity would be an interesting research topic. The current paper did consider the effects of purchase of foreign assets by selling bonds and shows that its effects are not very large. This policy is similar to the reverse of foreign exchange provision. However, since the demand for international liquidity is not explicitly modeled, the result of the paper may not be informative about the effect of foreign liquidity provision in practice.

Next, the types of unconventional monetary policies employed by emerging markets may depend on their economic structures. An important characteristic of emerging markets may be their dependence on foreign borrowing and risks of sudden stops. Dependence on foreign borrowing implies that those countries may not be able to lower the interest rates because low interest rates may put the countries at risk for capital outflow. The zero interest rate policy or quantitative easing are not options to them. Also, those countries tend to have less-developed domestic financial markets. Markets for securities and corporate bonds are much smaller. Then there may be no scope for credit easing.

The paper considers the credibility issue regarding commitment to a fixed interest rate. In general, commitment to a zero interest rate is time inconsistent. Therefore, the credibility issue analyzed in the paper is of practical concern. However, I think there is another credibility problem that is more relevant to emerging markets. Several emerging markets have less credibility regarding the long-run level of inflation. This can limit the types of unconventional policies they can use. This is because, compared with the traditional interest rate policy, unconventional monetary policies are less transparent and more discretionary. When the central bank has less credibility regarding the long-run inflation target and conducts quantitative easing, private agents might regard it as a sign of monetization, destabilizing inflation expectations.

Let me turn to some details of modeling. The model introduces three reduced-form frictions and estimates them. Quantitative evaluation is always welcome, but a question here is whether the estimated frictions really represent policy multipliers. First, the estimation period is from 2003 to 2009, which includes the period where unconventional monetary policies were not used. Then it is not very clear whether the estimated parameters really represent the effects of policy. Second, the Lucas critique says that policy evaluation based on a reduced-form model is problematic when expectations play a key role. This becomes particularly relevant when one analyzes credibility and anticipated vs. unanticipated policy.

Finally, it would be very important to identify the motivation behind the use of unconventional monetary policy. It can be a response to market malfunction. Examples include the Federal Reserve Board's purchase of mortgage-backed securities and the European Central Bank's purchase of government bonds. If this is the case, market malfunction should be explicitly modeled. It can also be an alternative to the interest rate policy after it hits the zero bound. An example would be quantitative easing. For emerging markets, since most countries used liquidity provision, their unconventional monetary policy may be justified as the responses to market malfunctions caused by foreign shocks. Relating to this point, let me finally comment on the results regarding the exit policy. It is shown that the exit policy is contractionary. However, I believe that this depends on whether a policy is a response to market malfunction or not. If the policy is a response to market malfunction and its effectiveness depends on the malfunctioning, then exit is not necessarily costly if markets recover their functions. On the other hand, if the policy is used as an alternative to the interest rate channel, then the exit policy may well be costly. In order to analyze this further, we need a microfounded model.

References

- Ishi, K., M. Stone, and E. B. Yehoue. 2009. "Unconventional Central Bank Measures for Emerging Economies." IMF Working Paper No. 09/226.