Ben vs. Mario: From Unconventional Monetary Policies to a Conditional Unemployment Target for the ECB!

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As a kind of Christmas present, the FED took a decisive step forward in its FOMC-decisions from December 12, 2012: Probably until 2015, the US unemployment rate of 6.5% will serve as the main monetary target, given price stability. This is a remarkable new development towards a more nuanced role of inflation targeting in monetary policies of central banks!

I. Bernanke´s Press Conference of December 12, 2012

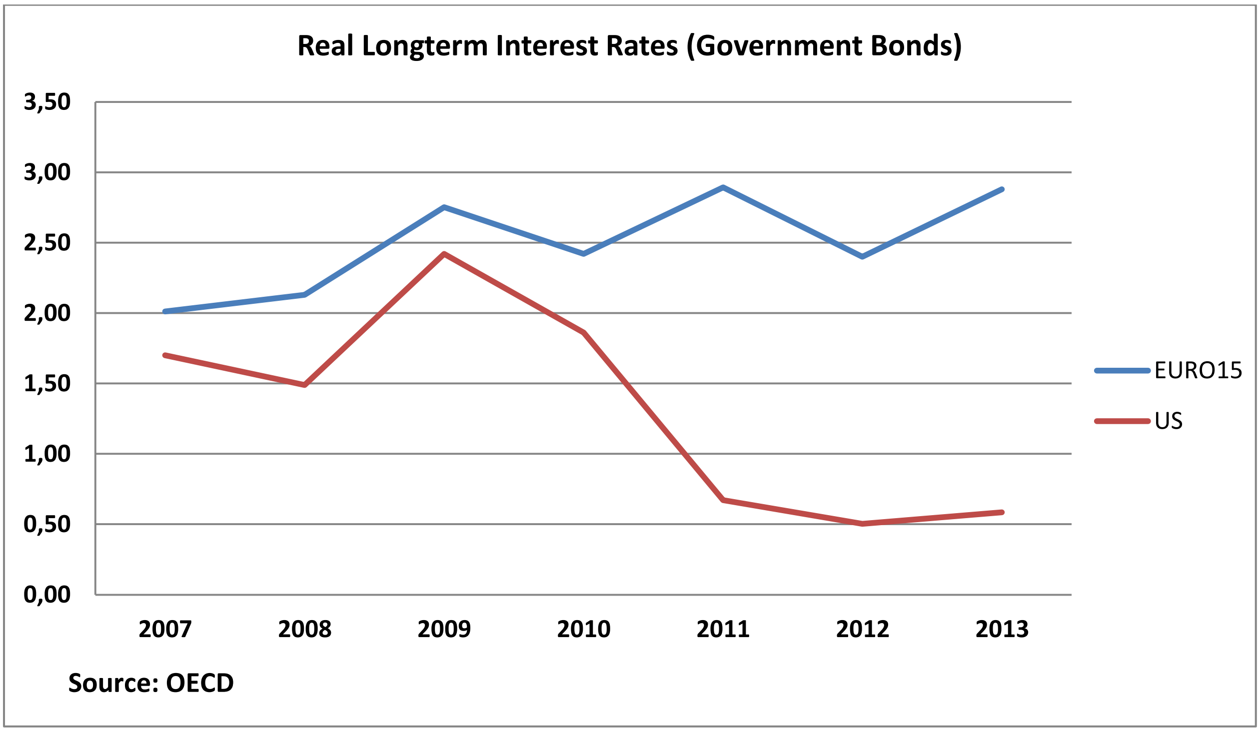
In his statement, Ben Bernanke highlighted to following points: "*The economy continues to expand at a moderate pace. Unfortunately, however, unemployment remains high … Against a macroeconomic backdrop that includes both high unemployment and subdue inflation, the FOMC will maintain its* ***highly accomodative policy*** *… In continuing its asset purchases, the Committee seeks to maintain* ***pressure on longer-term interest rates*** *…* ***we expect asset purchases until we see a substantial improvement in the outlook for the labor market****, in a context of price stability. In assessing the extent of progress,* ***the Committee will be evaluating a range of labor market indicators****, including the unemployment rate, payroll employment, hours of work, and labor force participation, among others … Specifically, the Committee anticipates that the exceptionally low levels for the federal funds rate are likely be warranted ´****at least as long as the unemployment rate remains above 6.5 per cent, inflation over the period between one and two years ahead is projected to be no more than half percentage point above the Committee´s 2 per cent longer-run goal, and longer-term inflation expectations continue to be well anchored****´… the Committee expects that the stated threshold for unemployment will not be reached before mid-2015 and projects that inflation will remain close to 2 per cent over that period."(highlighting by the author).*[2]

II. What have the ECB and the FED done since Lehman Brothers Bankruptcy?[3]

In the course of the financial crisis, both, the US Federal Reserve (FED) and the European Central Bank (ECB) started to reduce their key policy interest rates to a range between close to zero and 75 basis points, respectively. Further, the central banks of the United States and the EURO area started to adopt different kinds of unconventional policy measures. The Fed has bought US Treasuries but also large quantities of mortgage backed securities and other securities such as government and corporate bonds, other agency debt from private sector business like banks, pension funds and insurance companies. The aim was to affect the yields on a wide range of assets and to provide liquidity to markets that had dried up in the wake of the crisis. The ECB has used different instruments. It increased the maturity of its refinancing operations up to 36 months and expanded the assets banks post as collateral to the ECB. The substantial outflow of euro deposits from banks in some of the peripheral states has seriously impaired the transmission of monetary policy impulses to the wider economy. Hence, the EURO-system has conducted interventions in the euro area's debt securities markets by purchasing certain assets outright (instead of merely accepting them as collateral).

This Quantitative Easing (QE) had remarkable effects on the balance sheets of the ECB and the FED: they increased from 15% (end 2008) to almost 30% (early 2012) of GDP in the former case and to 20% of GDP in the latter. Of course, other effects are more important: By intention, QE should increase assets prices and reduce asset yields, and lower yields reduce the cost of borrowing for households and firms. These in turn should lead to higher consumer spending and more investment. And more cash should increase bank lending!

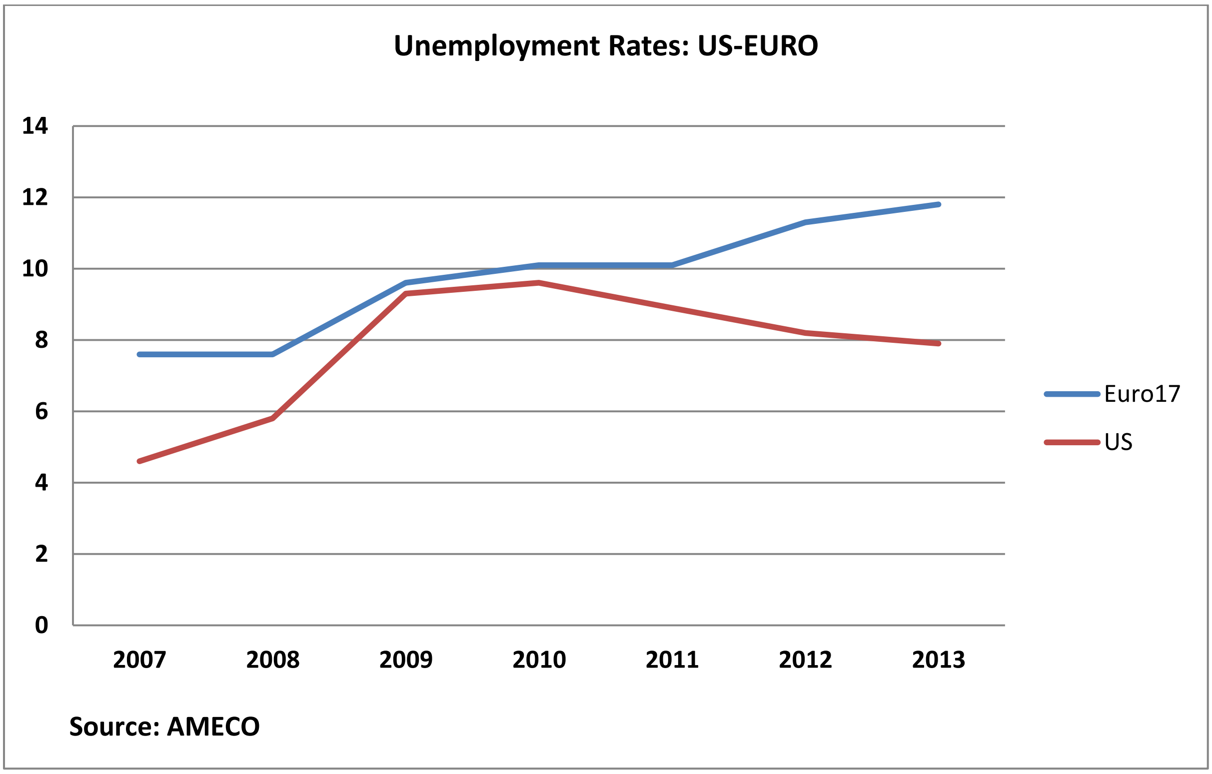
What about th empirical evidence of QE? The negative trend of annual growth in bank lending could be reversed in the EURO area and in the US in late 2009 (not so in UK) but growth came to a halt in the former in the first halve of 2012. As can be seen in Joyce et al. (2012, p. F282 ff.), government bond yields in the US and UK have been reduced by some 30-100 basis points through QE taking into account counterfactual developments. The figure below shows the overall picture of long-term interest rates in the US and the Euro-area, suggesting a more effective monetary policy of the FED.



III. **What effects had Unconventional Monetary Policies on GDP-Growth and Unemployment Rates in the US and the EURO-area?**

After a very similar movement of growth rates in the period 2007-2011, sluggish growth in the US and a double-dip recession in the EURO-area seem to be the main characteristics in 2012 and 2013. And unemployment is soaring in Europe while being on a downward trend in the United States since 2010 (see figure below). In separating the effects of QE on macroeconomic variables, Joyce et al. (2012, F285) conclude that large scale asset purchases (LSAP1 and LSAP2) in the US rose the level of real GDP relative to base by 3% and inflation by 1%. And as Giannone et al. (2012) have shown, the ECB lending to the banking sector increased EURO-area industrial production by 2% and reduced unemployment rate by 0.6 percentage points.[4]

So, unconventional monetary policies had their effects – but maybe these effects were not strong enough to prevent stagnation and deteriorating labour markets.



IV. Conclusions

"The very fact that the recovery in the Western economies remains so sluggish and weak suggests that either recessionary forces have been extremely strong; that QE does not work; that it has not been done in sufficient scale; or ***that its effect are limited and need to be supplemented with other measures****. The consensus of the literature and the articles in this volume is that* ***unconventional monetary policy does work*** *– asset market purchases do lower yields and longer term interest rates and these lower yields in turn have a positive effect on the economy … However, …., **its effects have not been enough to offset the negative forces of a banking crisis and a deleveraging-led downturn**. The implication is that central bankers and financial regulators **need to work on improving their macro and micro prudential framework**, …" (highlighting by the author).*[5]

To improve the prudential framework for the banking system, to purchase even more assets each month, and to go beyond inflation targeting by setting a conditional unemployment target, as the FED did it in December last year, should be considered the main policy options for the current bleak economic outlook. In the EURO-area, currently some 19 million unemployed are waiting for a job and some extra 10 million unemployed, the so-call "*discouraged workers*", gave up hope for finding employment; hence, in the EURO area, the "real" unemployment rate is around 16% rather than 11%; and no improvement in sight for the years to come!

Of course, it is completely unrealistic but it wouldn´t be the end of Western civilization if the ECB would set itself an unemployment target of some 6.5% unless inflation goes beyond, let´s say a 3% threshold. Inflation forecasts of the EU-Commission for the next two years hover around 2%. So no reason for central bankers to worry! The FED has changed its monetary policy strategy in this direction. The Bank of Japan is under way to increase the inflation target from 1% to 2% and will aim for "*more aggressive monetary easing*" (Shinzo Abe). Mark Carney, the new governer of the Bank of England, expressed his sympathy of nominal GDP-targeting strategy. This corresponds to higher inflation targets in times of sluggish growth. He says, central banks need to be creative in the post-crisis world. Only the ECB seems to be reluctant to be flexible. It´s a pity!

References

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Giannone, D., Lenza, M., Pill, H., Reichlin, L. (2012), The ECB and the Interbank Market, in: The Economic Journal, November 2012, F467-F486

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[1] I would like to thank an "anonymous referee" for extremely valuable comments. The usual disclaimer applies, of course.

[2] See Transcript of Chairman Bernanke´s Press Conference, December 12, 2012; http://www.federalreserve.gov/monetarypolicy/fomcpresconf20121212.htm

[3] For an intensive discussion of Quantitative Easing (QE) since 2008 see: The Economic Journal, Feature: Unconventional Monetary Policy after the Financial Crisis, Vol. 122, No. 564, November 2012.

[4] See Giannone et al. (2012), F482f.

[5] See Joyce et al. (2012), F286f.