

Central Banks Can Jump in but How Do They Exit Smoothly?

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As signs of economic stabilization have gradually emerged in various parts of the world, financial-market players have increasingly paid attention to the potential central banks' strategies to exit from the near-zero rate policy and unconventional monetary policy. An appropriate and timely exit strategy is particularly crucial in this crisis as risks from policy mistakes could be significant.

The main concern is whether central banks will be able to reverse the gear of their unconventional measures quickly and smoothly enough to ensure sustainable growth recovery without igniting economic instability.

There are three main types of so-called "unconventional measures" that central banks will have to exit from :

- Liquidity provisions
- Quantitative easing to bring down long-term interest rates through buying long-term government bonds
- Credit easing to revive the flow of credit through the purchase of commercial paper, corporate bonds and asset backed securities.

In choosing the exit strategies, central banks will need to revisit three main considerations. First, the speed and magnitude of the policy reversal are crucial for achieving a sustainable recovery over the medium term while maintaining credible inflation targets. The risk of choking off the economic recovery or imposing heavy losses from holding securities on lenders could rise if the policy reversal happens too abruptly.

On the other hand, the economy could suffer from heightened inflationary and asset-price bubble concerns if the draining of liquidity does not occur soon enough.

Secondly, the appropriate sequencing to unwind various measures depends on the original combination of policy measures implemented and subsequent macroeconomic developments as well as conditions in different sectors of the financial system in each country. For example, exiting from the liquidity-provision scheme could start first once the money market is back to normal conditions. Whether the rollback of quantitative easing to withdraw money injection should be done before a policy rate increase depends on the amount of liquidity prevailing in the system. Indeed, excessive liquidity would hamper effectiveness of monetary-policy tightening.

As for the reversal of credit-easing policy, central banks could unwind the measures once the credit market resumes its normal intermediation function for the economy again. Because economic recovery will not likely be robust; various market players expect that it will take quite some time before credit easing for certain credit instruments is unwound.

Lastly, communication of the planned policy reversal is crucial and should be formulated in a cohesive and transparent way such that it effectively anchors market expectations about future trends of inflation and economic activity. For example, the Bank of Japan's initial announcement about necessary conditions for ending quantitative easing before the actual termination in March 2006 was welcomed as it provided transparency and was beneficial for guiding future interest rate expectation.

Central banks' exit strategy from crisis-management measures should be well-planned in advance.

As with the adoption of the unconventional measures, policy-makers need to remind themselves that successful implementation will need to be flexible and depends largely on a proper evaluation about the prevailing conditions in the financial markets and the economy.

(The views expressed are the author's own.)

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