

Chapter 18

Unconventional Policy 4 – Exit Strategies

When central banks pursue conventional interest rate targets, officials think about the policy choices they face every six to eight weeks not as a series of one-off, unrelated decisions but as a *strategy* that influences expectations about the future path of their instrument and their objective. One may view central bankers as participants in a complicated game – like chess – that requires them to make moves today, keeping in mind moves that are far in the future.

Exiting from unconventional policies – such as the *duration commitments*, *quantitative easing* (QE) and *credit easing* (CE) that we previously discussed – also requires a future-oriented strategy. Absent a consistent and credible approach, policymakers may be unable to keep inflation expectations close to their inflation objective. And, if they fail, unstable inflation expectations could lead to broader economic instability.

Compared with conventional policy, exiting from QE and CE poses additional obstacles that appear technical, but have important implications. The key question is whether a central bank that wishes to raise interest rates will be *able* to do so as quickly as desired. With conventional policy, the answer is yes. In the case of QE and CE, the answer depends on the size and composition of the central bank's balance sheet and on the toolset available to the policymakers.

With conventional policy, a central bank that wishes to hike the policy rate can do so by modestly trimming the aggregate reserves that it supplies to the banking system. A central bank may hold sufficient short-term risk-free assets (such as Treasury bills) that it can reduce the supply of reserves merely by allowing some of these assets to mature. If necessary, the authorities also could sell a portion of these assets, which are among the easiest securities to sell (the most *liquid*).

However, what happens when QE and CE have ballooned reserves and assets on the central bank's balance sheet? Lacking other tools, the central bank may need to sell a large quantity of assets to reduce reserve supply sufficiently to raise the policy rate target. QE and CE assets typically are more difficult to sell (less *liquid*) than Treasury bills. Moreover, the value of any CE assets that default plunges. In these circumstances, a central bank may be *unable* to sell assets and withdraw reserves from the banking system rapidly enough to hike the policy interest rate when it desires.

Which tools can help the central bank to exit from QE and CE? Two mechanisms stand out. First, as we have seen, *the ability to pay interest on reserves* allows the central bank to separate the size of reserves supplied from the policy rate target, granting it two tools instead of one (see the Chapter 18 module: Paying Interest on Reserves). If a central bank hikes the interest rate paid on reserves, that rate becomes the new floor for the overnight lending rate that the central bank targets. If the central bank can raise this floor, it does not need to withdraw reserves rapidly

to raise the policy rate. Consequently, it can avoid a fire sale of its enlarged asset holdings. You may recall that Congress granted the Federal Reserve the authority to pay interest on reserves in October 2008 in the midst of the financial crisis.

Another approach is for the *central bank to issue its own liabilities* to the private sector. Banks purchasing these liabilities effectively reduce one-for-one their reserve deposits at the central bank. In effect, the central bank issuance *absorbs* reserves. However, some central banks, including the Federal Reserve, lack the authority to issue their own liabilities.

An alternative is for the fiscal authorities to issue liabilities and *deposit the proceeds at the central bank*. This approach has the same effect as if the central bank itself issued the liability. When commercial banks acquire the liabilities, they reduce their reserve deposits held at the central bank, so that reserves are absorbed. The Treasury and the Federal Reserve began to use this latter mechanism in October 2008 to allow the Fed to limit the impact of its massive asset purchases on the supply of reserves.

Given the complexities of exiting from unconventional policies, central bankers naturally avoid such tools except in extreme situations. Like good chess players, their awareness of future risks influences their policy decisions today. However, when short-term interest rates already are very low, the financial system in disrepair, economic activity in decline, and inflation sinking below their target, central bankers may have no better alternative. In such circumstances, a well-designed exit strategy can enhance their credibility and effectiveness.