Lessons From Unconventional Monetary Policy for Small Open Economies and Emerging Markets*

Douglas Laxton

Chang Yong Rhee

I feel very honored to be invited to this year's Jackson Hole Symposium, especially during this time of heightened uncertainty. The paper I'll be discussing is co-authored with Doug Laxton.

In response to an unprecedented health crisis, not only have central banks in advanced economies re-employed unconventional monetary policies (UCMPs) that had been used extensively since the global financial crisis, but these unconventional policies can also be found in emerging market and small open economies. With stronger rebound in aggregate demand than aggregate supply, and rising prices, inflation has soared to levels not seen in recent decades.

Amid these abrupt changes, we were asked to discuss new constraints from the perspectives of emerging market or small open economies. To be more concrete, we would like to explore two questions:

1. What lessons should emerging markets learn from the experiences of deploying unconventional policies in advanced economies? What implications do they have on current and sudden high inflation challenges?
2. Should emerging market economies use similar unconventional policies if they face strong deflationary pressure in the future?

By unconventional monetary policies, we mean quantitative easing (QE), as well as unconventional forward guidance (UCFG), which is qualitative, date-based or threshold-based forward guidance on the future paths of policy. The Fed's "lower-for-longer" expressions such as, "at least through mid-2015," or, "at least as long as the unemployment rate remains above 6.5%," are prime examples. This contrasts with

* We are grateful to Dr. Ahrang Lee and to Dr. Bada Han at the Bank of Korea for their substantive contributions and assistance in preparing this paper, and to Mr. Takuma Hisanaga at the MOF, Japan, for kindly providing the date that decomposes the main drivers of Japan's public debt accumulation. The views in this paper do not necessarily represent the official views of the Bank of Korea or its Monetary Policy Board.

"conventional forward guidance" (CFG), which utilizes a comprehensive forecast of macro variables with an endogenous interest rate path that is consistent with the objectives of the central bank.

How successful were UCMPs in advanced economies?

Let me first briefly mention how successful unconventional policies were in advanced economies. As you know, major central banks began encountering their effective lower bound in the aftermath of the global financial crisis and expanded their balance sheets massively in response to the ensuing recession. In addition, a discrete increase in major central bank assets occurred again during the COVID pandemic.

Abundant empirical studies have shown that these unconventional policies have been quite effective in lowering long-term interest rates and holding up output.

What are the drawbacks of UCFG?

Despite the successes in boosting economies, however, the experiences of unconventional forward guidance have exposed several weaknesses.

The first is the difficulty in communicating the conditionality and the time horizon of the guidance. An "oversimplified" communication strategy doesn't properly provide insights into how policy is likely to evolve in rapidly changing environments.

Second, such "oversimplification" leads markets to underestimate uncertainty, which probably makes it difficult for central banks to exit. A good example is the taper tantrum in 2013, in which a change in market perceptions triggered financial market turmoil, out of line with the modest policy tightening envisaged in the Fed's cautious public statements.

Third, such guidance can distort markets as the prolonged period of "r-g" less than zero could lead to fiscal irresponsibility. The potential reversion of "r-g" can then call into question debt sustainability in the new interest rate environment.

Another risk is the perception that the central bank is inclined to remain committed to forward guidance or risk credibility. This inflexibility could be a factor that has contributed to policymakers' current difficulties in dealing with the shift to a high inflation environment.

Practice of UCMPs in EMEs during the COVID pandemic

Although unconventional forward guidance has significantly contributed to economic stability after the global financial crisis, some of its weaknesses may have caused major central banks to recently discontinue unconventional forward guidance. Bloomberg called this "death" of forward guidance.

Then, what does this experience in advanced economies imply for emerging markets?

In fact, several emerging market countries also introduced QE-type policies together with large fiscal stimulus during the COVID pandemic, though at a much smaller scale. For instance, central banks purchased mortgage-backed securities or corporate bonds in Poland, Hungary and Thailand, as well as government bonds through primary markets in Indonesia and the Philippines.

Several studies have shown that unconventional measures have been relatively effective in emerging markets, too. Financial markets were stabilized without significant currency depreciation or capital outflows, despite massive expansionary monetary and fiscal policies, in some cases defying the taboo of buying government debt in the primary market.

Such effective uses, however, might have been attributed to a common global shock. Abundant global liquidity and the fact that advanced economies themselves were breaking taboos on a much larger scale might have helped emerging economies avoid being penalized by international capital markets for ultra-loose expansionary policies. It is therefore questionable whether the same results would be obtained if emerging markets alone were to face the risk of falling into secular stagnation and if they were to implement similar expansionary fiscal and monetary policies in response.

Constraints on UCMPs in EMEs

A more difficult question is whether emerging economies should use unconventional policies when facing secular stagnation, when global liquidity is not sufficient. The chance of returning to very low inflation and low growth is significant for Korea and other Asian emerging economies, such as Thailand and China, considering their rapid aging and earlier experiences of low inflation.

Even so, unconventional forward guidance may not be a desirable toolkit for emerging markets with greater uncertainty, exacerbating the inflexibility of unconventional forward guidance to sudden economic changes and the exit problem.

In addition, there are several structural factors to consider. For unconventional forward guidance to be successful, the central bank must be able to commit to the announced strategy and make a credible case that it is consistent with achieving the central bank's objectives. Otherwise, the central bank could be subject to aggressive speculative attacks. For example, unconventional policies trying to lower interest rates could lead to excessive depreciation of the local currency if the market perceives the policy as being inconsistent with the macroeconomic fundamentals of the country.

Concerns about fiscal dominance is another example. The experience of Japan since the 1990s well-illustrates that the main driver of public debt explosion has been aging-related spending, not fiscal spending to boost the economy as is commonly believed. This shows that it is not easy for emerging economies that are experiencing rapid aging, to credibly convince markets of a scenario that temporarily requires a large fiscal stimulus while promising to maintain fiscal sustainability in the long-term.

An alternative conventional forward guidance

So, if unconventional forward guidance is not desirable, then what are the alternatives?

One option could be scenarios-based conventional forward guidance. For example, in summer last year, this framework could have been used to present different scenarios for the two clear narratives regarding inflation: persistent vs transitory.

The first scenario would have assumed inflation was more persistent, requiring faster policy normalization. In contrast, the transitory scenario would have assumed that inflation was purely supply-driven and the inflation pressures were temporary, and therefore, the central bank would be committed to supporting an economy still recovering from COVID.

This framework might have helped major central banks to better manage the constraints on monetary policy during the recent transition from a low- to high-inflation environment.

Controversies in the transition to scenarios-based CFG

Despite its attractiveness, there are also considerable objections to applying scenarios-based conventional forward guidance to emerging markets.

First, monetary policies in emerging market and small open economies are heavily affected by policies in advanced economies. They may have improved their independence from the government, but still cannot be independent from the Fed. Therefore, rather than solely relying on the interest rate, alternative policy tools, such as FX intervention, macroprudential tools, and sometimes capital flow management measures, need to be utilized as well. The Integrated Policy Framework (IPF) by the IMF and Macro-Financial Stability Frameworks (MFSFs) by the BIS address this issue. In these circumstances, some believe that it is technically impossible to construct a simple baseline and reasonably small number of alternative scenarios.

Communication difficulties are another problem. The information contained in conventional forward guidance may be useful to market experts in that alternative scenarios can guide them when the realized state of the economy deviates from the baseline. However, the realization of an alternative scenario could be interpreted differently by the general public, as perhaps that the central bank is an incompetent forecaster.

A recent Bank of Korea policy decision is a good example that illustrates these controversies. In July, the BOK raised its policy rate by 50 bps for the first time in its history. Given that market participants already anticipated a 50-bp rate hike, forward guidance on the future policy path, rather than the current interest rate hike, became even more important.

After debating the aforementioned pros and cons, a compromise approach was taken. In the official statement, we only included qualitative remarks such as "The Board sees continued rate hikes as warranted." Then, we provided more detailed forward guidance during the press conference, such as saying that "gradual, 25-basis-point increases will be appropriate for some time as long as inflation paths remain as currently presumed." This was intended to give us more flexibility on the future policy path, while providing the minimal forward guidance that market experts would like.

Concluding Remarks

In conclusion, we believe that unconventional forward guidance is not an ideal policy tool for emerging market and small open economies, where exit strategies must be sought more frequently. Insufficient central bank credibility and a potentially larger impact on fiscal dominance, debt sustainability, and currency depreciation make unconventional forward guidance a far riskier option than in advanced economies.

However, considering the possibility of facing secular stagnation due to fast aging in the future, emerging markets do not have the luxury of giving up QE and forward guidance completely. They had better start to build up a better policy framework, such as scenarios-based conventional forward guidance.

Admittedly, trying to build an analytical framework that can accurately predict the future course of the economy would be overly optimistic.

But I'd like to remind you of Stanley Fischer's famous quote of Samuelson: "I would rather have Bob Solow than an econometric model but I'd rather have Bob Solow with an econometric model than without one."

To develop unconventional tools which are robust to their specific needs and issues, it's time for emerging market or small open economies to invest in building analytical capacity, strong implementation records, and extensive research.

Thank you very much.