Conventional versus unconventional monetary policy

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Abstract

This paper offers information regarding the different types of conventional and unconventional monetary policies. It supplies content that is relevant to how these different policies affect the markets. Specifically, this paper provides information on the three different policies that are used under conventional monetary policies, unconventional monetary policies, how they are compared and when to use the unconventional monetary policies. These policies are in use in everyday life and affect everyone that is touched by the financial sector.

Conventional monetary and unconventional monetary policies are used by central banks to affect output, interest rates and money supply. Traditionally, there are three conventional monetary policies that are used by central banks and all three will be covered first. Then there are also three unconventional monetary policies that are used by central banks but are not quite as traditional since the most recent policy was used in 2008. The unconventional monetary policies that will be discussed are the ones that are the most used since they are effective. After you know what types of policies are out there and how they affect the economy, we will compare the conventional and unconventional monetary policies to see how they are used to the same end but in different economic conditions. The economic conditions of a country determine whether or not to use the conventional or unconventional monetary policies. Basically, you need to know whether to tighten or ease monetary policy, where your country is on the spectrum to know whether to use the conventional or unconventional monetary policies and what the different type of policies are and how they are used.

There are three different types of conventional monetary policy: open market operations, reserve requirement ratios and the discount window. Diving into the first of the three policies, open market operations, is when the central bank decides to buy or sell short term government bonds. The way that the federal reserve bank can affect money supply is to sell one of these short term bonds (which is also selling the U. S. dollar) that when purchased will increase the supply of money in the public's hands and will decrease the interest rate. The second type of conventional monetary policy is the discount window. The discount window is where the central bank acts as a lender of last resort, for commercial banks that are experiencing illiquidity. This type of monetary policy affects banks through their lending practices. For example, when lending decreases then deposits decrease resulting in an increase in the discount rate and causing the money supply to decrease. The third type of monetary policy is the required reserve ratio. The required reserve ratio is the fraction of deposits that regulators require a bank to hold in reserve and not loan out. (Grimsley) The current required reserve ratio for large banks set by the Federal Reserve is ten percent of liabilities for 115. 1 million dollars or more in net transaction accounts. (Reserve) The required reserve ratio calculation is required reserve ratio equal to required reserve divided by deposits. How commercial banks find out how much of a reserve they need to comply with the Federal Reserve is to take their deposits multiplied by the required reserve ratio and the resulting dollar amount will be how many dollars they must keep in reserve. These deposits in banks are counted as part of the money supply which is money supply is equal to currency plus deposits, so an increase or decrease in either would result in a change in money supply. Banks may also keep

more than the necessary amount in reserve. The extra deposits that are kept in reserve are called excess reserve and banks that would like to do interbank loans must have excess reserves to loan to other banks. Once you have these excess reserves you can participate in the Federal Funds Market in which only big commercial banks are able to participate. Those banks who do participate in the Federal Funds Market are subject to a Federal Funds Rate which is the equivalent of LIBOR (London International Bank Offered Rate) but only in the U. S. banking system. It is also worth noting that Federal Funds Rate is lower than the discount rate, giving incentives for banks not to borrow from the Federal Reserve Bank. Each of the three before mentioned monetary policies are accepted widely by central banks. Now we need to see what happens when additional factors affect the market and break the convention.

Unconventional monetary policies are used when the conventional monetary policies are not able to be used anymore. These unconventional policies are used when short term bond rates (or the FFR, Federal Funds Rate) is close to zero percent or when there are concerns about deflation or deflation is already a factor in the economy. We use the Fisher equation to predict the nominal interest rate which is equal to the real interest rate plus the expected inflation rate. The conventional policy fails when the nominal interest rate is equivalently equal to zero. It is worthwhile to note that during economic recessions the real interest rate (used in the Fisher equation) is driven by the central bank to be less than zero to promote lending and borrowing that will increase investing and, eventually, output. That action can affect the economy in an adverse way and lead, among other things, to

need unconventional monetary policies. The three most widely used, and the ones that will be discussed, of the unconventional policies are: forward guidance, credit easing and quantitative easing (QE). The first policy covered is forward guidance, it affects things like planning based on interest rates. Forward guidance monetary policy affects the long term interest rate because of the expectations theory. The expectations theory is a formula for long term interest rates and the central bank uses this by keeping short term interest rates low (FFR equivalent to one percent) to drive down long term interest rates. Low interest rates improve credit availability and will lead to an increase in invest that will eventually stimulate the economy. It should be noted that this unconventional policy will have the most impact if the central bank has a high reputation. The next unconventional policy is credit easing. Credit easing is a policy that has been in use since 2008 and is the government purchasing private sector assets, for example corporate bonds and residential mortgage backed securities. By the government purchasing private sector assets, they provide liquidity to those markets that have been sagging. This happens by the government providing more funds which lead to more loans that result in more of the public buying those assets. Credit easing provides a boost to markets that have been hindered for one reason or another to provide growth and eventually boost output. The third unconventional policy is quantitative easing, a policy in which many industrialized countries have used since the great recession. Quantitative easing is quite similar to open market operations, as discussed before, but instead of buying and selling short term bonds, the government buys and sells long term government bonds. Using this policy will lead to an increase in the demand for long term bonds which will increase the price of long term

bonds. This will drive down the interest rate of long term bonds (because bond prices and interest rates are inversely related) leading to an increase in investment which will lead to purchases in infrastructure that will result in an increase in output (GDP). Quantitative easing seems to be a solid unconventional policy since so many industrialized countries are using it as an instrument to grow out of their recessions. All of the unconventional policies seem to be effective at achieving growth to counter deflation.

Comparing the unconventional and conventional policies can lead to curious discoveries about how some policies may seem quite the same when they are in various ways different. For example, take quantitative easing and open market operations, they both seem quite similar at a glance. Both of these policies are the buying and selling of bonds to the public sector. There is just one major difference, open market operations are buying/selling short term bonds and quantitative easing is buying/selling long term bonds so they are similar but different. Another example is the discount window and credit easing, they both provide liquidity to the public sector but in different ways. The discount window policy provides a lender of last resort and the credit easing policy provides liquidity to different markets that are sagging. These policies, both conventional and unconventional monetary policies, have the same goal which is to provide a stable economy that provides growth while maintaining a balanced budget like. They use the interest rate and bank reserves to drive money supply in a way that the central bank thinks will best achieve those goals. It is easy to generate growth in output in the short run but it is much hard to do so in the long run, hence the need for policies like the balanced budget.

Conventional and unconventional monetary policy are used to curb output in a similar manner but using the instruments in a different fashion. The different conventional monetary policy tools are the generally used policies to affect money supply. When the country experiences deflation or short term interest rates are close to zero then central banks switch to the different unconventional monetary policy instruments to affect output. Both are different but similar in different respects and are joined by the overall goal of sustainability and increased output. Each policy type can and is an effective instrument in controlling money supply and output. A countries central bank just must perform the policies at the right time to make these instruments effective.

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