ARTICLE – Foreign central banks’ plans for a gradually less expansionary monetary policy

During the coronavirus crisis, central banks have conducted an expansive monetary policy by keeping policy rates low and, in many cases, by purchasing both publicly and privately issued securities. The central banks have purchased securities to make monetary policy more expansionary in a situation where policy rates have been deemed to be at or close to their effective lower bound. Another aim has been to improve the efficiency of monetary policy by supporting specific credit markets that have functioned poorly. The central banks’ holdings of securities are now large. The future development of these holdings will therefore affect the global financial conditions.

Many economies have come far in the recovery from the coronavirus crisis and, in many places, the holdings of securities that were primarily purchased for market maintenance purposes have already been phased out or are being phased out. As the economic situation continues to improve, the question arises of what central banks will do with their large bond holdings and policy rates. The information so far communicated by central banks has some common features. Several central banks have resolved or communicated that the first step will be to lower the rate of bond purchases (tapering), before keeping the holdings constant for a time by reinvesting principal payments. Some central banks expect, as a next step, to ensure that their policy rate reaches some way above its effective lower bound before they start reducing their bond holdings. There are also differences in central banks’ plans and actions, among other things concerning purchases of private assets and how the reduction of securities holdings will proceed.

Historically large securities holdings and low policy rates

Many central banks, including the Riksbank, have used a number of different monetary policy tools during the coronavirus crisis. In general, the central banks have cut their policy rates to levels where further cuts are deemed ineffective (see Figure 12 in Chapter 2). In addition, the central banks have purchased significant volumes of securities, with both public and private issuers, to keep interest rate levels down and facilitate monetary policy transmission by counteracting deteriorated functionality of specific markets that are important to the credit supply in the economy. With similar aims, the central banks created various facilities last year to facilitate access to liquidity in important parts of the financial markets. Overall, the measures seem to have contributed to the rapid recovery of the global economy by preventing the hard impact of the coronavirus pandemic on the economy from resulting in a financial crisis. An important part of this has been ensuring that access to credit at low interest rates has been good, despite the heavy shocks entailed by the pandemic.

The central banks' holdings of securities are now very large (see Figure 11 in Chapter 2) and also include different types of assets. What the major central banks choose to do with their securities holdings when they judge that monetary policy needs to be made less expansionary may therefore have significant consequences for interest rate levels and economic developments worldwide.

Several tools are available to eventually decrease the stimulus

The restraining effect of the pandemic on the developed economies is now starting to ease, employment is rising and inflation is above central bank targets in several countries. In this situation, major central banks' plans for a less expansionary monetary policy have come into focus with market participants and other economic analysts.

In this situation, central banks are facing several questions and trade-offs, such as how changes to the policy rate and the size of the securities holding can be used to regulate the expansiveness of monetary policy. Another question concerns how large the holdings should be in the longer term and how rapidly they should be allowed to decrease. The remaining time to maturity of a central bank's holdings can also affect these deliberations. If the holdings consist of bonds with a long remaining time to maturity, a sale could be more appropriate. In addition, there may be differences, from asset type to asset type, concerning both the manner in which holdings will be reduced and the phase in which it may happen. For example, when a market is again functioning well, securities primarily purchased to counteract a temporary disturbance on this market may be phased out earlier and faster than securities purchased with the aim of lowering the general level of interest rates.[18]

In its latest monetary policy report, the Bank of England has given a clear account of its strategy for the gradual reduction of monetary policy stimulus and has specified the order in which it expects the policy rate to be raised and securities holdings decreased.[19] Considering that the effects of changes in the policy rate can be assessed with greater certainty than those of changes in the securities holdings, and that it is also easier and faster to implement policy rate changes, the Bank of England expects to be able to raise its policy rate before it starts to reduce its securities holdings. This is intended to create scope for later use of the interest rate to counteract possible unexpected negative effects of the reduction of securities holdings or other shocks requiring further stimulus. Once the Bank of England has raised the policy rate to 0.5

[18] For an overview of possible reasons to start a reduction of securities holdings at an early stage, see K. Forbes, "Unwinding Monetary Stimulus in an Uneven Economy: Time for a New Playbook?" August 2021, www.kansascityfed.org/documents/8341/Forbes_Unwinding_Stimulus_in_an_Uneven_Economy_final.pdf.

[19] "Box A: The MPC's strategy for the mix of monetary policy instruments to deliver tighter policy", Monetary Policy Report, August 2021.

per cent, it will be time to start reducing the securities holdings, initially by ceasing to reinvest principal payments. In a later phase, once the policy rate has reached 1 per cent, it may become appropriate to reduce holdings more rapidly through active sales. However, the Bank of England does not expect to sell so much that its balance sheet does not stay significantly larger than it was ahead of the financial crisis.

Other central banks' strategies and plans

The US central bank, the Federal Reserve, is currently continuing to make net purchases (extending its holdings) of government bonds and mortgage backed securities. On the other hand, it has terminated purchases and reduced holdings of commercial paper and corporate bonds, as well as interest-bearing instruments with short maturities issued by states and local authorities.[20] The Federal Reserve has described the conditions that need to be fulfilled for it to cut down on its net purchases, as well as further conditions for when, later on, it may become appropriate to raise the policy rate (see also Chapter 2).[21] The minutes of the monetary policy meeting in July reveal that the Federal Open Market Committee (FOMC), which decides on monetary policy, discussed whether the economy had approached the targets for employment and inflation closely enough for it to be appropriate to start purchasing securities at a slower rate.[22] The Committee also discussed whether purchases of mortgage backed securities should be tapered faster than purchases of government bonds.

The Federal Reserve has not communicated in which phase holdings of government bonds and mortgage backed securities shall start to be phased out. The last time the Federal Reserve was in a similar situation, in 2014, following several years of recovery from the financial crisis, it explained that several policy rate rises would be implemented before the asset portfolio would be allowed to shrink.[23] The asset portfolio would be phased out through principal payments rather than active sales, with the expectation of long-term securities holdings that were significantly smaller than they were at the time but larger than prior to the financial crisis. In the long term, the holdings would primarily be focused on government bonds, to avoid a lasting effect on the allocation of credits between different sectors. After the new securities purchases that were made to mitigate the economic consequences of the coronavirus crisis and the recent review of its monetary policy strategy, the Fed's communication has not included correspondingly clear indications of the phase in which a possible reduction

[20] Purchases of commercial paper, corporate bonds and interest-bearing instruments with short maturities issued by states and local authorities were carried out with the approval, and occasionally the capital, of the US Treasury that has subsequently announced that this approval and support would be withdrawn at various points in 2021.

[21] See speech by J. H. Powell, 27 August 2021, www.federalreserve.gov/newsevents/speech/powell20210827a.htm.

[22] Net purchases refer to the total purchases (gross purchases) minus the principal payments taking place over the same period. In other words, net purchases of an asset lead to an increase in the holdings of that asset. Normally, the word 'tapering' means a reduction in the rate of net purchases and thereby a lowering of the rate at which holdings increase. A more detailed description of the FOMC discussions can be found in the minutes of the FOMC meeting of July 2021.

[23] "Policy Normalization Principles and Plans", dated 17 September 2014 with addenda dated 18 March 2015 and 13 June 2017, www.federalreserve.gov/monetarypolicy/files/fomc_policynormalization.pdf.

of the securities holding would be initiated. At the same time, it has made it clear that it will be a long time before an initial rate rise becomes appropriate.[24]

The European Central Bank (ECB) has two programmes for asset purchases: the APP (Asset Purchase Programme), initiated in 2014, and the PEPP (Pandemic Emergency Purchase Programme), initiated in March 2020 to mitigate the economic consequences of the pandemic. Net purchases of both public and private securities are still under way in both of these programmes. Under the framework of the PEPP, the ECB expects to make net purchases of securities until the coronavirus crisis is deemed to be over and no earlier than the end of March 2022. At its September meeting, the ECB decided to recalibrate monthly purchases to a lower rate. As regards net purchases of assets under the framework of the APP, the ECB GC has indicated that it expects to terminate these just before policy rates start to be raised. The holding of securities under APP is to be maintained for an extended period after policy rate rises have been initiated. Principal payments on assets purchases under the PEPP will be fully reinvested by the end of 2023 at latest and the "future roll-off of the PEPP portfolio will be managed to avoid interference with the appropriate monetary policy stance".[25] Consequently, at present, it has not been clearly expressed what this will mean for the PEPP holdings.

Earlier in the year, the Bank of Canada concluded its programme aimed at supporting the functionality of important financial markets, including a programme for purchases of mortgage bonds and corporate debt securities. It is still purchasing government bonds but the rate of these purchases has gradually been tapered off with reference to the increasingly strong economy. In a speech held in March this year, Deputy Governor Gravelle said that he expected to move from net purchases of government securities to maintaining the holdings by reinvesting principal payments for a time before starting to raise the policy rate.[26]

Major central banks are continuing to pursue an expansionary monetary policy

Few central banks have presented their exact plans in any great detail as economic developments are always uncertain and it needs to be possible to adapt monetary policy to new information. However, certain common features can be discerned in their communication as regards the large bond holdings. Several of the central banks are clear that they see a cautious and gradual management of these holdings ahead. Initially, the rate of net purchases will be cut, meaning that the holdings will continue

[24] For example, at a press conference on 16 June 2021, Chairman Jerome Powell stated that the focus now lay on asset purchases and that a first rate rise lay well into the future. See www.federalreserve.gov/media-center/files/FOMCpresconf20210616.pdf.

[25] See the ECB's Economic Bulletin, March 2021, , www.ecb.europa.eu/pub/pdf/ecbu/eb202102.en.pdf..

[26] Other central banks have not communicated as much about their longer-term strategies and plans for their securities holdings, but it may be worth noting that the Reserve Bank of Australia has lowered the rate of its securities purchases with reference to the stronger economic recovery; that the Reserve Bank of New Zealand recently ceased asset purchases and has announced that policy rate rises will be on the way over the coming year; and that Norges Bank, which cut its policy rate to 0 per cent in conjunction with the coronavirus pandemic but has not had a securities purchase programme, has announced that it will soon be appropriate to raise its policy rate.

to increase, albeit at a declining rate.[27] Furthermore, the larger central banks that have clearly communicated on this subject, which is to say the ECB and Bank of England, have indicated that they expect their policy rates to be raised before they allow their bond holdings to be decreased. The Bank of England has clarified that its aim in this is for the policy rate to have had time to be raised a bit more above its effective lower bound before asset holdings are reduced, so that the possibility of using the policy rate to adjust the expansiveness of monetary policy has been regained. Furthermore, the central banks that have addressed the matter of the future size of their securities holdings have indicated that these will be significantly smaller than today in the long term but larger than prior to the financial crisis.

At the same time as there are certain common features in central banks communications of how they see the development of their securities holdings in the period ahead, differences are also apparent. Several central banks have already discontinued the purchases of private securities they initiated during the coronavirus crisis for market maintenance purposes, such as purchases of corporate debt securities. But this does not apply to them all – for example, the ECB is still purchasing a broad set of public and private securities. There are also signs that central banks, to an extent, have different plans for whether securities holdings must always be held to maturity or whether the holdings can also be reduced by sale. It is natural to reach different conclusions in this matter, among other reasons because experiences of how decreased holdings will affect economies are limited and because the financial systems have different characteristics in different countries.

The many important and difficult questions provide reason to expect more discussion and more clarifications of the central banks' plans for policy rates and securities holdings in the period ahead.

[27] In the research literature, it is the size of the central bank's holdings that is normally decisive for how securities purchases affect interest rates and, ultimately, the economy as a whole. See also J. Alsterlind, H. Erikson, M. Sandström and D. Vestin, "How can government bond purchases make monetary policy more expansionary?", Economic Commentaries, No. 12, 2015. To the extent that it is the proportion of outstanding stock in the holdings that determines expansiveness, the outstanding stock's development is also significant in practice – if central government debt grows, net purchases may be needed to retain the degree of expansiveness. The actual purchase rate may also be significant for interest rate levels and thereby expansiveness for other reasons, particularly in markets with low liquidity under stressed market conditions. Ultimately, the significance of holdings and purchase rates is an empirical matter and the factual material here is not extensive, making definitive conclusions hard to reach.