Unconventional Monetary Policy: Effectiveness and exit Strategy

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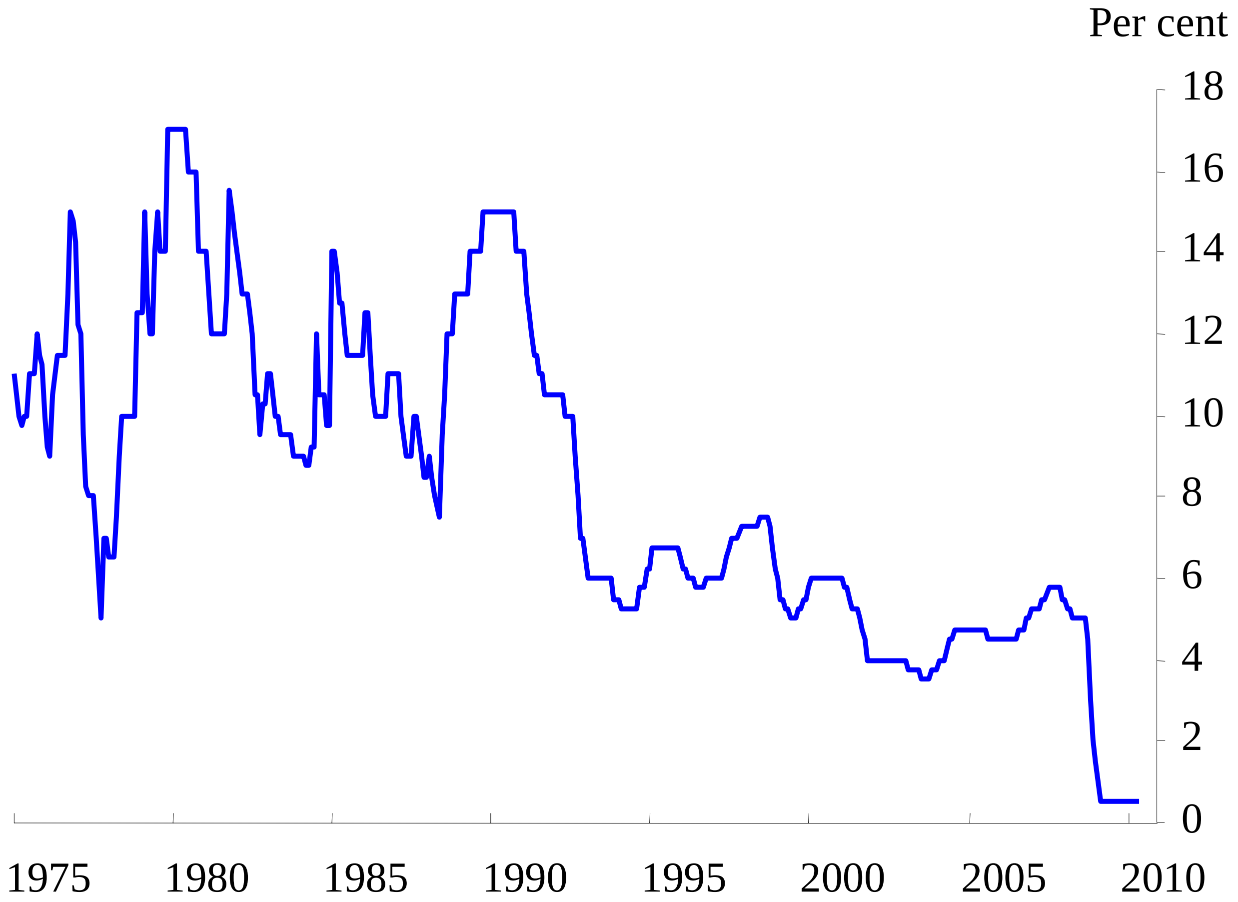
Monetary policy: Bank Rate



Asset Purchase Programme

- Purchased both government and corporate debt
- Funded by issuance of reserves (central bank money)
- Treasury indemnity against losses
- MPC voted in March 2009 to purchase £75 billion (5% of annual GDP)
- Increased over time to £200 billion (14% of annual GDP)

Economics of QE

- Workhorse model (New Keynesian, new classical synthesis) suggests QE will not work (Eggertson and Woodford 2003)

- Irrelevance proposition based on very specific assumptions
  - Representative agent
  - Complete markets

- Results very similar to Ricardian equivalence

- Need more general models for analysing monetary policy at lower bound.

Models of imperfect substitutability

- **Micro models**
  - Tobin (1958)
  - Brunnermeier and Pedersen (2009), liquidity constraints faced by market makers
  - Vayanos and Weill (2008), use search model to explain liquidity premium on “on-the-run” stocks

- **Macro models (incorporating financial frictions)**
  - Kiyotaki and Moore (2008), firms face liquidity constraints in financing investment
  - Gertler and Kiyotaki (2009), funding friction for banks
  - Andres, Lopez-Salido and Nelson (2004), imperfect substitutability between short and long-term bonds

How is it working? Key channels

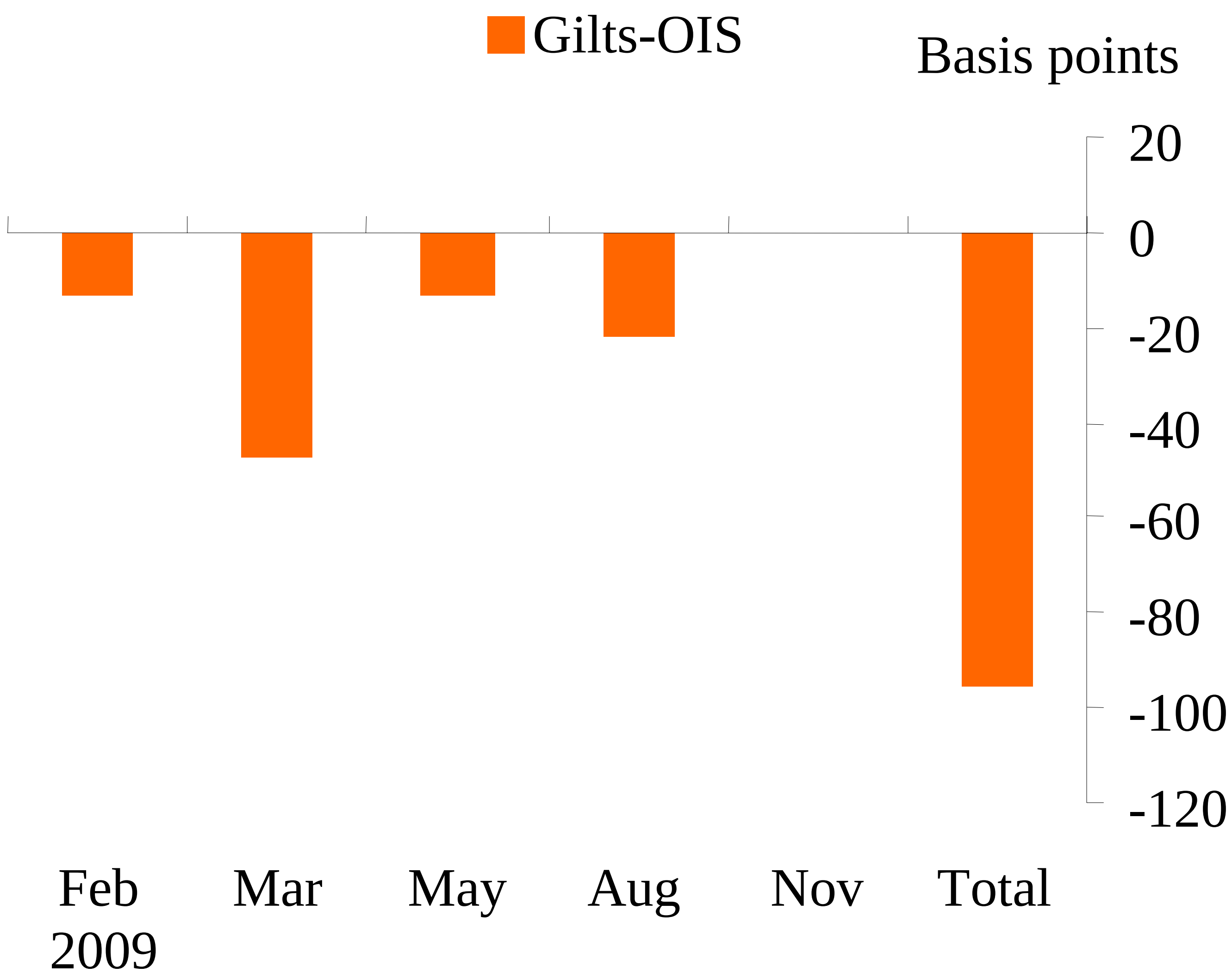
- Portfolio channel – reallocation by investors
- Liquidity channel – unblocking corporate credit markets
- Inflation expectations

What did we hope for?

- Increased money
- Reduced gilt yields
- Improved functioning of corporate credit markets
- Higher corporate bond and equity prices
- Increased capital markets issuance
- Higher nominal spending

Impact of asset purchases

On Gilt-OIS spreads over two days following QE announcements



Exit strategy

- Strategy: Outlook for inflation relative to the target
- Instruments: Raise Bank Rate and sell assets
- Policy mix to be decided. But likely that Bank Rate will be raised first, with assets sold in an orderly programme
- Major challenge is not the exit procedure, but getting the timing right

Other Issues

- Monetary/Fiscal policy mix
- Design and operation of Macro Prudential policy
- Transition path to a safer banking system
- Long-run structure of the banking system

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THE END