Conventional Monetary Policy and the Zero-Lower-Bound

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Original post here.

Central banks across the world have eased monetary policy to facilitate smooth market functioning during the Covid-19 crisis. Interest rate cuts are their primary policy tool. Global interest rates are now at historic lows, with 14 of the 38 central banks in a Bank for International Settlements (BIS) database setting their nominal key policy rates at or below 0.25 percent; three are below 0.

This post provides an overview of recent policy rate trajectories and discusses the constraints that policymakers face, as well as possible avenues for further accommodation through the interest-rate channel, with nominal rates at or approaching zero in many countries.

Global interest rates

All countries in the BIS database with positive policy rates before the crisis have announced cuts since the beginning of the year, with the exception of Hungary and Croatia. The United States and Canada have cut their rates the most among major economies, both by 150 bps. Canada lowered its overnight target rate from 1.75 percent to 0.25 percent in three announcements between March 4 and March 27. The current target rate is lower than the rate of 0.5 percent that the bank targeted at the height of the Global Financial Crisis (GFC) between April 2009 and May 2010. Similarly, the Fed lowered its target for the federal funds rate by 150 bps following two unscheduled FOMC meetings on March 3 and March 15. With a target range between 0 and 0.25 percent, the funds rate returned to the level it stood at in the wake of the GFC, before the Fed engaged in a series of interest rate hikes starting in December 2015.

Most countries have cut their target rates in one or two announcements, with only a small number of central banks making three or more successive cuts. Among countries that have only made a single announcement, India and New Zealand made the largest adjustments to their policy rate; both countries cut their target rate by 75 bps. The Reserve Bank of New Zealand cut its official cash rate from 1 to 0.25 percent on March 15, the lowest target in the bank's history.

Argentina and Turkey cut their rates the most. The central bank of Argentina has cut its rate by 1700 bps since the beginning of the year. However, those adjustments don't constitute an immediate reaction to Covid-19, but reflect the slowdown of inflation in the country; they are part of an ongoing effort to normalize monetary policy. Turkey announced four successive cuts between January 17 and April 23, lowering its target rate by 325 bps from 12 percent to 8.75 percent. While the first two announcements were made in the context of an ongoing disinflation process, the central bank mentioned a need to address weakening economic activity due to the Covid-19 crisis in its two most recent announcements.

Some central banks have not cut rates at all. This is the case for the Swiss National Bank (SNB), the Bank of Japan (BOJ), and the European Central Bank (ECB). All three had a target rate at or below zero at the onset of the crisis and did not provide further accommodation through this policy channel. The central bank of Hungary also maintained its target rate despite having a positive policy rate at 0.9 percent. The central bank of Croatia uses the exchange rate of the euro against its domestic currency to guide monetary policy, it did not include an interest rate target in its response to the current crisis.

Denmark was the only central bank to raise its target rate. Danish policymakers raised the target rate from negative 0.75 to negative 0.60 percent on March 19 to ease downward pressure against the Danish crown and maintain its fixed exchange rate with the euro.

The Zero Lower Bound constraint

Negative interest rates are one possible avenue for further accommodation through the policy rate channel at the Zero Lower Bound (ZLB). Another avenue is forward guidance, that is, expressing the central bank's commitment to maintain rates at a low level for a prolonged period of time.

As the nominal interest rate approaches zero, central banks' ability to cut interest rates through open market operations is limited as investors can choose to hold currency instead of securities. Currency holdings carry zero interest and thus provide a natural floor to interest rates. In practice, however, large cash holdings have associated risks and costs, allowing some central banks to set negative interest rates.

Currently, Switzerland, Japan, and Denmark have the only central banks with a negative interest rate target, which all three implemented before the current crisis. The central bank of Sweden had a negative policy rate since February 2015 but returned to a target at a nominal rate of zero on January 8, 2020.

The Swiss National Bank (SNB) has the lowest target rate globally. Its policy rate has stood at negative 0.75 percent since January 15, 2015, to counter the upward pressure on the Swiss franc and to maintain its exchange rate with the euro within an appropriate range. The BOJ has maintained a low rate since the Asian financial crisis. Its policy rate has not exceeded 0.5 percent since September 8, 1995; it has been negative since September 21, 2017. The ECB has maintained its key policy rate, the rate on main refinancing operations (MRO), at zero since March 2016.

Finally, a number of central banks recently set policy rates at or below 0.25 percent, leaving them with limited room for further accommodation through conventional rate cuts. This is the case for the central banks of Australia, Canada, Israel, New Zealand, Norway, Peru, the United Kingdom, and the US.

Banks that do not set negative policy rates can provide further relief to market participants by communicating a commitment to maintain accommodative policy rates for some time. This can be explicitly stated as a period of time during which the bank commits to maintain its rate or implicitly by communicating that rates will be maintained until a policy objective is achieved. The Reserve Bank of New Zealand issued explicit forward guidance with its most recent rate cut, promising to maintain the target rate at 0.25 percent for 12 months. Meanwhile, the ECB tied expectations to a quantified policy objective, committing to announce no further changes in interest rates until "the inflation outlook robustly converges to a level sufficiently close to, but below, 2%." In the US, the Fed promised to maintain its range until "it is confident that the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals."