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Evergreen temporary policy measures may pose hidden risks

History has shown that the next crisis may hit us before policy makers have exited from the stimulus measures applied during the previous emergency. The limits of monetary policy have been significantly extended in recent years both by introducing new policy tools, as well as by going beyond what has previously been the norm with traditional instruments, such as lowering the interest rates.

Most of the non-standard measures applied during the last decade have been initially proposed as temporary measures to address a very rapid fall in activity. As the economic outlook and the conditions in the financial markets have not improved significantly, the extensive policy support has become long lasting. By introducing temporary policy measures, we understandably focus on their expected short-term positive impact. Given their intended short-lived use, there is less of a need to worry about their long-term effects, which in any case are also more difficult to foresee. Decisive action by central banks has worked well by easing the financing conditions at times where markets where freezing up or by supporting the gradual recovery. Nevertheless, we should refrain from viewing the very accommodative policy stance as the new standard just because it has been around for long.

An important innovation during the last crisis was the ability to utilize the extra policy space provided by negative rates. Following the conventional logic of banking, negative rates might trigger dramatic changes in business models. The fact that negative rates would be introduced only for a limited time was expected to mitigate this risk. Now that ultra-low rates have been around for longer than initially expected, we need to study the impact this might have on the term structure of interest rates, business models in the financial sector, or changes in the real economy.

When temporary measures last longer, they may bring about structural changes that are not the expected outcome of the policy. Structural shifts in the financial sector caused by the prolonged accommodative policy stance can be viewed as unintended side effects of monetary policy. While change is natural and there might be nothing wrong with the financial sector adjusting to new policies, there may also be changes that weaken policy transmission.

Asset purchases by central banks have led to flatter yield curves and lessened the turbulence in financial markets. But there is also the risk that central bank interventions may weaken the role of markets in adequately pricing the credit risk. This in turn may hold back favourable structural changes in the private sector and necessary reforms in the public sector, both leading to lower productivity. “You cannot fix the roof when the house is on fire” and similar considerations are valid during the days of an acute crisis.

However, one should be careful not to plant the seeds for the next crisis by allowing short-term relief provided by policy measures to continue for too long. We know that debt levels and asset prices tend to become elevated, as interest rates remain low for a long period. High levels of debt in turn can limit the upper bound of policy rates, since financial and political stability concerns may emerge.

A timely exit from temporary emergency measures as the economic outlook gradually improves is just as important as decisive policy action during the acute phase of a crisis. This will minimize the risk of undesirable side effects of accommodative monetary policy kept in place for longer than strictly necessary. Other factors can facilitate a timely exit from non-standard policy measures.

For example, a fully functional Capital Markets Union can contribute to a more efficient transmission of the monetary policy. In addition, a regulatory environment that encourages the creation and use of financial buffers in the real, financial and the public sector may improve the resilience of the economy and reduce the need for policy support. ●