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MONETARY POLICY IS LESS POWERFUL IN RECESSIONS

Changes to key interest rates by central banks have a significant impact on economic activity during periods when the economy is expanding. Unfortunately, they seem to have virtually no effect during recessions – the time when the stimulus of monetary policy is most needed.

These are the central findings of research by Professor **Silvana Tenreyro** and **Gregory Thwaites**, published by the new Centre for Macroeconomics at the London School of Economics.

The study focuses on the Fed Funds rate, the main monetary policy instrument used by the US Federal Reserve and the counterpart of the Bank Rate set monthly by the Bank of England. The researchers explore the effect of changes in this 'policy rate' on US macroeconomic activity over a 40-year period – from 1969 until 2008. Whether central bank interventions of this kind can stimulate activity is a key issue for policy.

The analysis shows that nearly all of the effect of the policy rate on economic activity over the business cycle is attributable to changes made during good times – and it is particularly driven by the responsiveness to rate changes of business investment and consumer spending on durable goods.

A possible explanation is that during recessions, many people decide simply not to buy expensive durables and hence a change in the interest rate does not affect how much they buy. In good times, in contrast, people are buying durables and the level of the interest rate may affect how much they buy.

Whatever the precise mechanism, the researchers find that in an expansion, output and inflation fall in response to an increase in the policy rate in the textbook fashion. But in a recession, the responses of output and inflation to a rate cut are negligible.

Professor Tenreyro comments:

> 'Our findings have important implications for the design of economic policy.
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> 'If changes in the policy rate have little impact in a recession, central banks need to resort to other measures to achieve the desired expansionary effect – 'quantitative easing' and 'forward guidance' are current examples.
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> 'Our results also suggest that policy-makers may need to rely more heavily on fiscal or financial policies to stabilise the economy in a deep or protracted slump.'

A key issue when studying the effect of monetary policy interventions is causality: when output is contracting – or falling below potential – a central bank is more likely to lower the policy rate (and conversely, when output is expanding, a central bank is more likely to increase the rate). This policy reaction in principle impairs any causal interpretation of the relationship between policy rates and economic activity.

To estimate the causal effect of policy changes in economic activity, the new study relies on a narrative approach to measure policy changes that are exogenous (that is, not reacting to economic developments). By using the Fed's historical records of Federal Open Market Committee meetings, the authors identify historical episodes in which the policy change is not driven by developments on the real side of the economy.

The test of whether monetary interventions matter consists of assessing whether (and how much) activity responds following a monetary policy change. The researchers then use state-of-the-art econometric techniques to analyse whether the response of the economy to changes in the policy variable differ depending on whether the economy is in a boom or bust, finding significant responses only during booms.

ENDS

Notes for editors:

'Pushing on a string: US monetary policy is less powerful in recessions' by Silvana Tenreyro and Gregory Thwaites is the first study published by the new Centre for Macroeconomics at the London School of Economics.

The Centre for Macroeconomics brings together world-class experts to carry out pioneering research on the global economic crisis and to help design policies that alleviate it. The centre encompasses experts from Cambridge University, London School of Economics (LSE), University College London (UCL), the Bank of England and the National Institute of Economic and Social Research (NIESR).

Five major research programmes address the key issues of unemployment, fiscal austerity, financial markets, shifts in the world economy and the development of new methodologies.

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