

What convention?

A Keynesian perspective on unconventional monetary policies

Luca Fantacci and Jacopo Maria Magurno (Università degli Studi di Milano)

“EXCEPTION. Say it proves the rule but don’t venture to explain how.”

G. Flaubert

This contribution explores the origin of the notion of "unconventional monetary policies" to better contextualize the debate over their unfolding. Subsequently, it builds an analysis of these policies, as they have been implemented in the last 15 years, through the lens of the theories and proposals elaborated by John Maynard Keynes. More specifically, it questions the "unconventional" character of such policies through the notion of "convention" as elaborated in chapter 12 of the General Theory. According to Keynes, the normal functioning of financial markets relies on the preservation of a conventional assumption postulating the preservation of liquidity and the ongoing interchangeability of various types of money and assets. This work shows how so-called unconventional monetary policies have been implemented, paradoxically, to sustain confidence in this conventional basis of valuation.

1. Non-conventional monetary policies

Traditionally, central banks have relied on the manipulation of short-term interest rates to influence economic activity. This approach, often referred to as "interest rate steering", depends on the relationship between the central bank’s established policy rate and other market rates to transmit monetary policy decisions throughout the economy (Bindseil, 2004; Borio 1997). Central banks typically select a market rate they can effectively influence—most often the overnight interbank rate—as their primary operational target. As Claudio Borio aptly described, it is in the interbank market, a “relatively unglamorous and often obscure corner of the financial markets, that the ultimate source of the central banks’ power to influence economic activity resides” (Borio 1997, p.14). This influence is exerted primarily through open market operations, complemented by other instruments such as standing facilities and reserve requirements. Guided by macroeconomic models, the policy rate is set to influence intermediate targets, which subsequently shape broader economic outcomes. For central banks, this constitutes the challenge of monetary transmission (Braun and Downey 2020, pp.13 – 14).

It is important to emphasize that this approach is the result of a historically specific process of institutional convergence. Starting in the late 1970s, central banks worldwide began to gradually move away from so-called "direct methods" of monetary control—such as interest

rate ceilings and credit controls—and quantitative targets. Instead, they focused increasingly on the steering of short-term interest rates (Kneeshaw and Van den Bergh, 1989; Borio, 1997). Crucially, this transformation was a trial-and-error processes requiring capacity building and incremental innovations, all while accommodating the institutional specificities of national financial systems (Passacantando, 1996; Best, 2019; 2020).

The consensus around interest rate steering solidified during the Great Moderation, a period from the late 1980s to 2007 characterized by relative macroeconomic stability and low inflation (Cesaratto and Febrero, 2024). During this time, monetary economists celebrated what they believed to be a scientific and predictable approach to central banking (Marcussen 2009; Mudge and Vauchez, 2019). The perception of monetary policy as a purely technical endeavour reached its peak during this period, exemplified by the growing autonomy granted to central banks worldwide—a paradigm usually referred to as central bank independence (Masciandaro and Romelli 2015).

The global financial crisis of 2007, however, marked a turning point. Central banks across the globe were compelled to adopt new practices that extended beyond the steering of short-term interest rates, representing a significant departure from pre-crisis implementation frameworks (Borio and Zabai, 2016). Many of these practices had already been trialled in Japan during the 1990s in response to prolonged economic stagnation and deflationary pressures. Confronted with the zero lower bound (ZLB) on nominal interest rates, the Bank of Japan implemented quantitative easing (QE) and other measures to stimulate demand and stabilize financial markets. As the Bank of Japan noted in a 2001 press release, these measures were "unlikely to be taken under ordinary circumstances" (cited in Bindseil 2004, p. 41).

These practices came progressively to be known as unconventional monetary policies (UMPs), to distinguish them from the "conventional" interest rate policies that had become entrenched in central banking over the preceding decades (Bindseil and Fotia 2021). UMPs were originally framed as tools for extraordinary circumstances in contrast with the "conventional policies" suited for so-called "normal times". Over time, however, UMPs have gradually become an integral part of central banks' operational toolkits, with the effect of blurring the boundaries between normal and extraordinary time (Borio and Zabai 2018, p.1).

While many possible classifications exist, building on Bindseil (2014) and Borio and Zabai (2018), we classify UMPs as follows:

- Balance Sheet Policies
 - Large-Scale Asset Purchases (QE 1): Central banks purchase financial assets, including government and private-sector securities, to inject liquidity into the economy and influence long-term interest rates.

- Long-Term Lending Operations (QE 2): Central banks provide funding to financial institutions under non-standard conditions, such as extended maturities or targeted lending purposes.
- Communication Policies
 - Forward Guidance (FG 1): Managing expectations about the future trajectory of central bank balance sheets and asset purchase programs.
 - Forward Guidance (FG 2): Steering market expectations regarding the future path of interest rates ("interest rate forward guidance").
- Negative Interest Rate Policy (NIRP): Setting nominal policy rates below zero to encourage lending and spending.

2. J.M. Keynes: the convention at the basis of the investment system

In analysing the functioning of the investment system, and more specifically of financial markets, Keynes introduces a peculiar notion of convention, which may serve to elucidate what kind of convention is at stake in what are commonly called “unconventional” or “non-conventional” monetary policies.

The relevant passages are contained in chapter 12 of the *General Theory*, where Keynes discusses the state of long-term expectations, and their role in determining investment decisions. The latter are characterized, according to Keynes, essentially by the conditions of radical uncertainty under which they must be made. In deciding how much to invest, businesses are faced with the need to compare immediate costs with prospective net returns. Hence, they must formulate forecasts that depend on variables, of which they ignore not only the value, but even the probability distribution:

"The outstanding fact is the extreme precariousness of the basis of knowledge on which our estimates of prospective yield have to be made." (1936: 149)

Investment decisions are, for Keynes, the starting point of the economic system, the ultimate determinant of the level of economic activity and employment. Hence their importance at the core of the *General Theory*, of which chapter 12 is, not by chance, the central chapter, the keystone, so to speak. Now, the starting point for the analysis of investment decisions is, as Keynes observes in the passage we just quoted, the “precariousness of knowledge”, on which they have to be made.

What Keynes is arguing here is not merely that our knowledge is limited in relation to the plethora of factors that concur to determine the profitability of investments in a complicated world. If this were the case, it would merely be a matter of increasing the amount of data available to investors and the computing power required to elaborate it. Instead, Keynes is pointing here to the intrinsic “precariousness” of knowledge in the face of what he describes as radical uncertainty: the impossibility to reduce many phenomena to mathematical probabilities. The main concern of his *Treatise on Probability* remains at the core of the theory

of investment in the *General Theory*: on what basis can choices be made, when “we simply do not know” (Keynes 1937).

Indeed, we know very little about the future, and even specifically about the circumstances that will affect the return on investment, and yet investment decisions must be, and in fact are, continuously taken to allow innovation and production, and ultimately to satisfy all needs and desires. How, then, are those decisions taken?

“In practice we have tacitly agreed, as a rule, to fall back on what is, in truth, a convention. The essence of this convention—though it does not, of course, work out quite so simply—lies in assuming that the existing state of affairs will continue indefinitely, except in so far as we have specific reasons to expect a change.” (152)

The convention consists essentially in an assumption concerning the predictability of the factors that affect the returns on investments. Ultimately, what the convention implies is that investors are capable of creating reliable mathematical models to predict future yields. However, as Keynes had argued in his *Treatise on probability*, for most phenomena involved in investment decisions we lack sufficient reasons to make a similar assumption.

“But it is not surprising that a convention, in an absolute view of things so arbitrary, should have its weak points. It is its precariousness which creates no small part of our contemporary problem of securing sufficient investment.” (153)

The convention that market operators adopt to deal with the precarious basis of their knowledge introduces a precariousness of second order, so to speak. If the starting point for investment decisions is “the precariousness of the basis of knowledge” in the face of radical uncertainty, the point of arrival of the convention that guides those decisions is another precariousness in the confidence with which the convention itself is held. Therefore, the assumption on which we ground our predictions of the future is itself precarious and is liable of being suddenly abandoned whenever confidence in the predictability of the future falters.

“[B]eing based on so flimsy a foundation, it is subject to sudden and violent changes. The practice of calmness and immobility, of certainty and security, suddenly breaks down. New fears and hopes will, without warning, take charge of human conduct. The forces of disillusion may suddenly impose a new conventional basis of valuation. All these pretty, polite techniques, made for a well-panelled Board Room and a nicely regulated market, are liable to collapse.” (Keynes 1937: 214-5)

The crisis of confidence appear in the form of a shift from one convention to another: from one convention, which consists in the assumption that we can predict the future and which therefore encourages investments on the stock market, to another convention, which views money as the ultimate store of value, as a safe haven in the face of uncertainty capable of defending the value of investments from the vagaries of the future, and which therefore

induces to liquidate all investments on the stock market and to keep wealth in the form of cash.

“Why should anyone outside a lunatic asylum wish to use money as a store of wealth?

Because, partly on reasonable and partly on instinctive grounds, our desire to hold Money as a store of wealth is a barometer of the degree of our distrust of our own calculations and conventions concerning the future. Even tho this feeling about Money is itself conventional or instinctive, it operates, so to speak, at a deeper level of our motivation. It takes charge at the moments when the higher, more precarious conventions have weakened. The possession of actual money lulls our disquietude; and the premium which we require to make us part with money is the measure of the degree of our disquietude.” (Keynes 1937: 216)

The liquidity preference reflects this fluctuation from one convention to the other. Stock market crises appear as a competitive struggle to liquidate all investments:

“The immediate causes of the financial panic – for that is what it is – are obvious. They are to be found in a catastrophic fall in the money value not only of commodities but of practically every kind of asset, – a fall which has proceeded to a point at which the assets, held against money debts of every kind including bank deposits, no longer have a realisable value equal to the amount of the debt. We are now in the phase where the risk of carrying assets with borrowed money is so great that there is a competitive panic to get liquid. And each individual who succeeds in getting more liquid forces down the price of assets in the process of getting liquid, with the result that the margins of other individuals are impaired and their courage undermined. And so the process continues... The competitive struggle for liquidity has now extended beyond individuals and institutions to nations and governments” (Keynes 1932).

Similar crises, which are usually described generically as confidence crises or liquidity crises, consist more precisely, following Keynes, in a loss of confidence in the basic convention on which decisions on financial markets are based.

It is precisely to face similar situations that Keynes suggests several policy interventions, which anticipate what we call today “nonconventional monetary policies”.

The first measure designed to contrast the effects of a liquidity crisis is the purchase of long-term securities by the central bank, so as to counter the tendency of long-term interest rates to remain high as a consequence of an increase in the liquidity preference of a loss of confidence in the ability to make long-term forecasts on the profitability of investments. This may be regarded as an anticipation of quantitative easing.

“Perhaps a complex offer by the central bank to buy and sell at stated prices gilt-edged bonds of all maturities, in place of the single bank rate for short-term bills, is the most important practical improvement which can be made in the technique of monetary management”. (Keynes, 1973A, p. 206)

A second measure proposed by Keynes to contrast liquidity crises, i.e. crisis of confidence, is the attempt by the central bank to influence directly the expectations of market operators, providing them with an anchor, particularly for the forecasts of future interest rates. A similar proposal is based on the conventional character of the interest rate as liquidity premium and anticipates what we now call forward guidance:

“the rate of interest is a highly conventional, rather than a highly psychological, phenomenon. For its actual value is largely governed by the prevailing view as to what its value is expected to be. Any level of interest which is accepted with sufficient conviction as likely to be durable will be durable” (Keynes 1936, CWK 7, p. 203)

A third measure is aimed at strengthening the convention on which predictions are based by weakening the convention that views money as a store of value. Such measure consists in imposing on money balances, a negative interest rate or artificial carrying cost. This policy, inspired by the theory and practice of Silvio Gesell, anticipates what today we call negative interest rate policies.

“Those reformers, who look for a remedy by creating artificial carrying-costs for money through the device of requiring legal-tender currency to be periodically stamped at a prescribed cost in order to retain its quality as money, or in analogous ways, have been on the right track; and the practical value of their proposals deserves consideration” (Keynes, 1936, CWK 7, p. 234)

Altogether, we can say that Keynes anticipated several measures that today fall under the name of nonconventional monetary policies. His analysis allows us to understand better in what sense the convention is at stake in such unconventional policies: following Keynes, we can regard the latter as different ways to face and counterbalance the collapse of the peculiar, precarious convention, on which the functioning of financial markets is based. Unconventional monetary policies are not merely extraordinary measures for extraordinary times. They are an attempt to restore the convention. In times of uncertainty, when the convention has broken down and investors lack confidence on their ability to predict prospective returns, to calculate and compare the net present value of future income streams. Non-conventional monetary policies may be regarded as a form of lending of last resort designed to bail out not this or that individual actor, but the entire financial system. The most appropriate description of central banks in this capacity may be drawn from an inscription in old coins: *defensor fidei*. Through nonconventional monetary policies, central

banks aim at restoring the confidence, the faith, on which the stability of the entire financial system ultimately rests.

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