IMPROVING ECONOMIC POLICY

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Monetary policy normalisation of major central banks and financial risk

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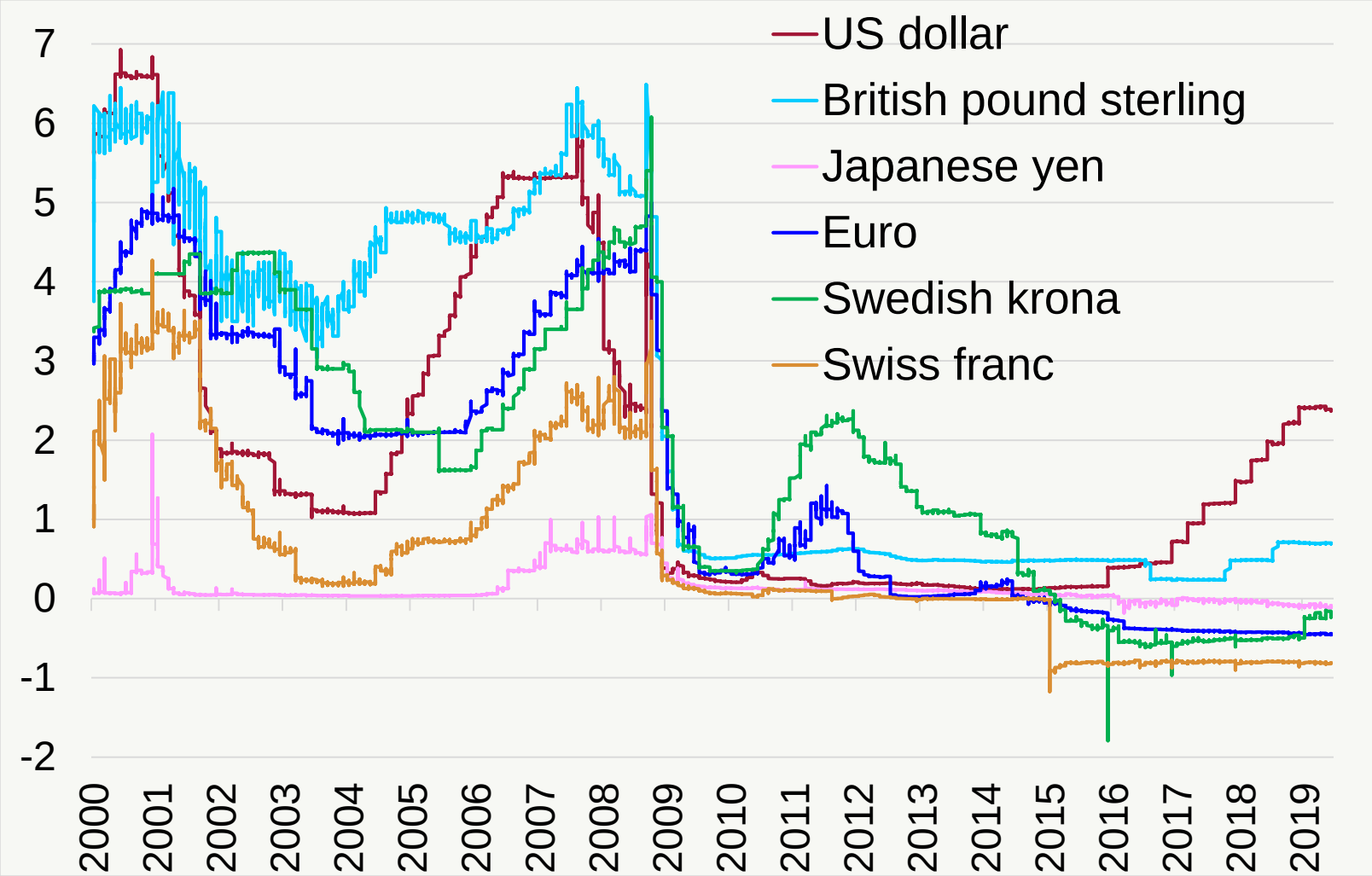
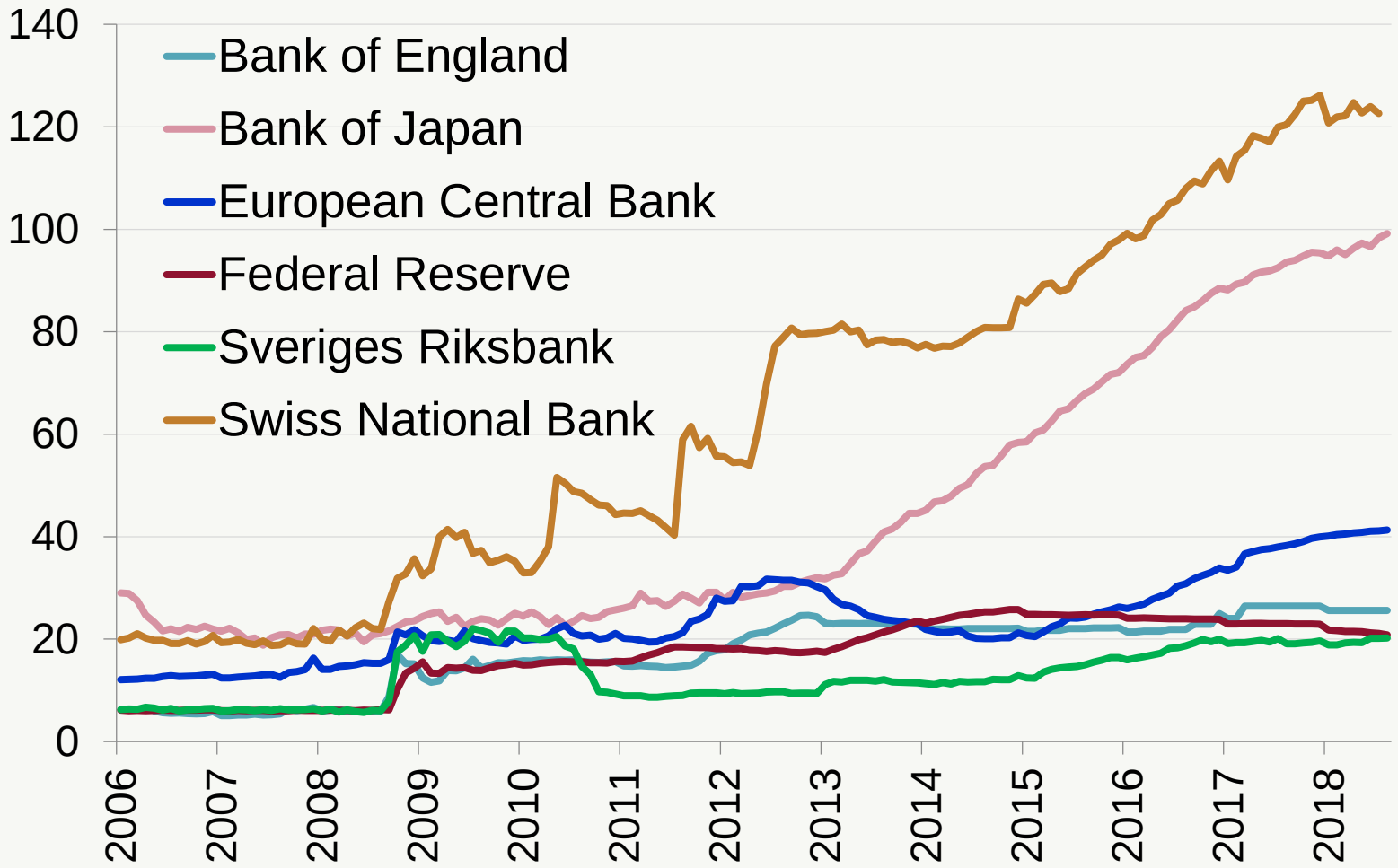
One-week interbank interest rates (%), 2 January 2000 – 14 June 2019



- Federal Reserve: sizeable tightening since late 2015
- Bank of England: some tightening since late 2017
- Other 4: low interest rates remain
- But temporary tightening in 2011 by the ECB and the Swedish central bank

Central bank balance sheet (% GDP)



- Sizeable differences in pre-crisis balance sheet sizes
- Even more so after 2008
- Switzerland: mainly foreign currency purchase
- Others: purchase of various securities, including government bonds

Monetary policy normalisation questions

- **Interest rates**: when to raise and up to what ‘new normal’?
- **Central bank balance sheet**: shrink or not? And to what level?
- **Financial stability**: expansionary monetary policies, and their normalisation, could create financial risks. Should monetary policy aim to support financial stability?

Outline

1. New normal in monetary policy
2. Lessons from monetary policy exit mistakes of Sweden, the US and the UK
3. ECB monetary policy exit when the inflation outlook is uncertain
4. Monetary policy and financial stability

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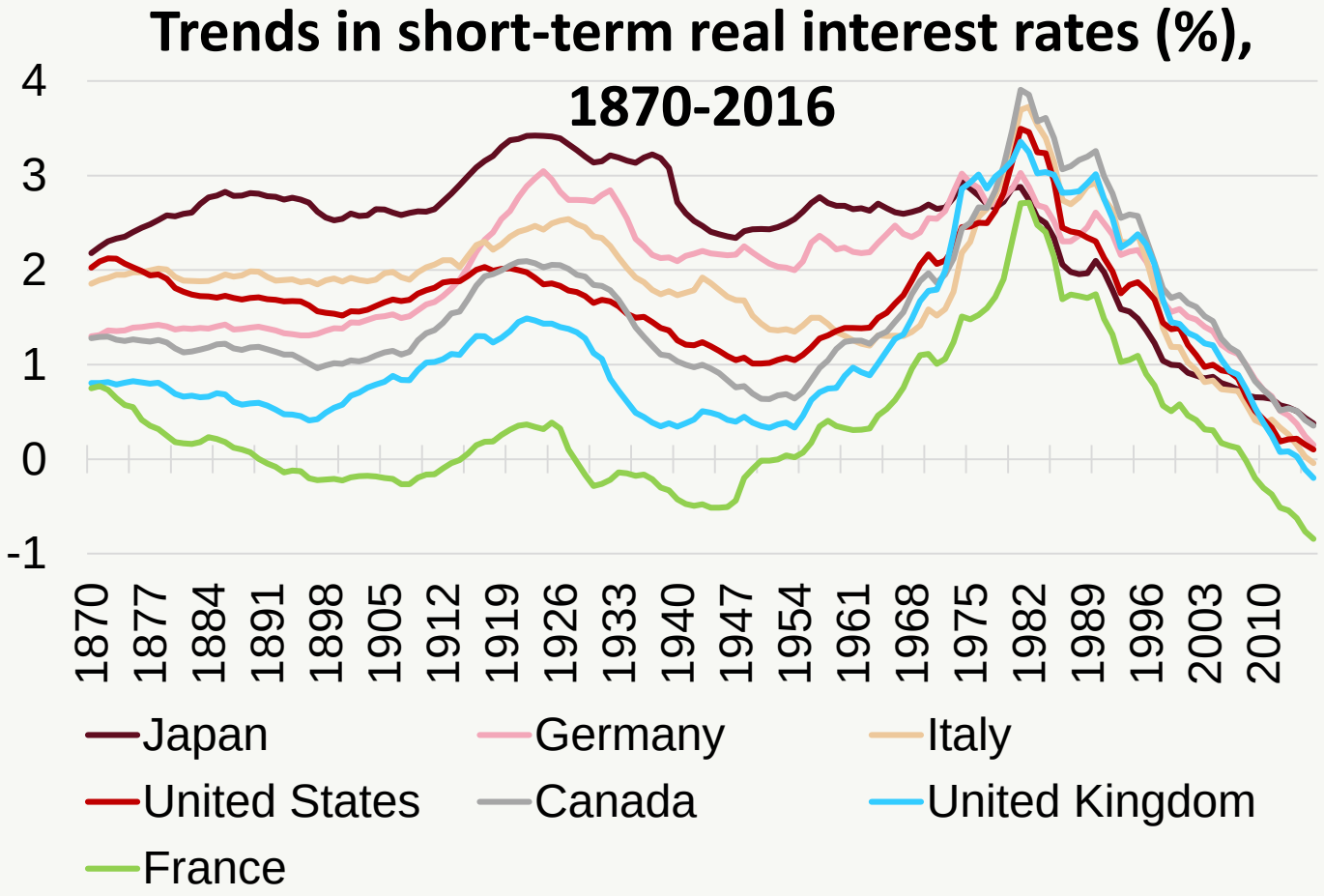
1. New normal in monetary policy?

Secular decline in global real interest rates



Source: Del Negro, Marco, Domenico Giannone, Marc P. Giannoni and Andrea Tambalotti (2018) 'Global Trends in Interest Rates', NBER Working Paper No. 25039

Explanations of the secular decline in global real rates by Del Negro *et al* (2018):

- Increase in the premium that international investors are willing to pay to hold safe and liquid assets (scarcity of safe assets in the context of a global saving glut)
- Lower economic growth

Blanchard (2019): low interest rates will likely prevail

Central bank balance sheet

- No benchmark for ‘normal’ balance sheet
- Balance sheet depends on the way monetary policy is conducted, on the exchange rate regime, past monetary policy actions, central bank tasks, profit distribution
- Arguments in favour of larger balance sheet:
  - (1) Lower equilibrium interest rate → zero lower bound will likely be reached more frequently → unconventional monetary policy would be used more regularly;
  - Larger balance sheet could (2) improve monetary transmission, (3) provide safe assets, (4) reduce banks’ incentives for excessive maturity transformation
- Arguments against larger balance sheet:
  - It exposes the central bank to financial risk and undue political influence

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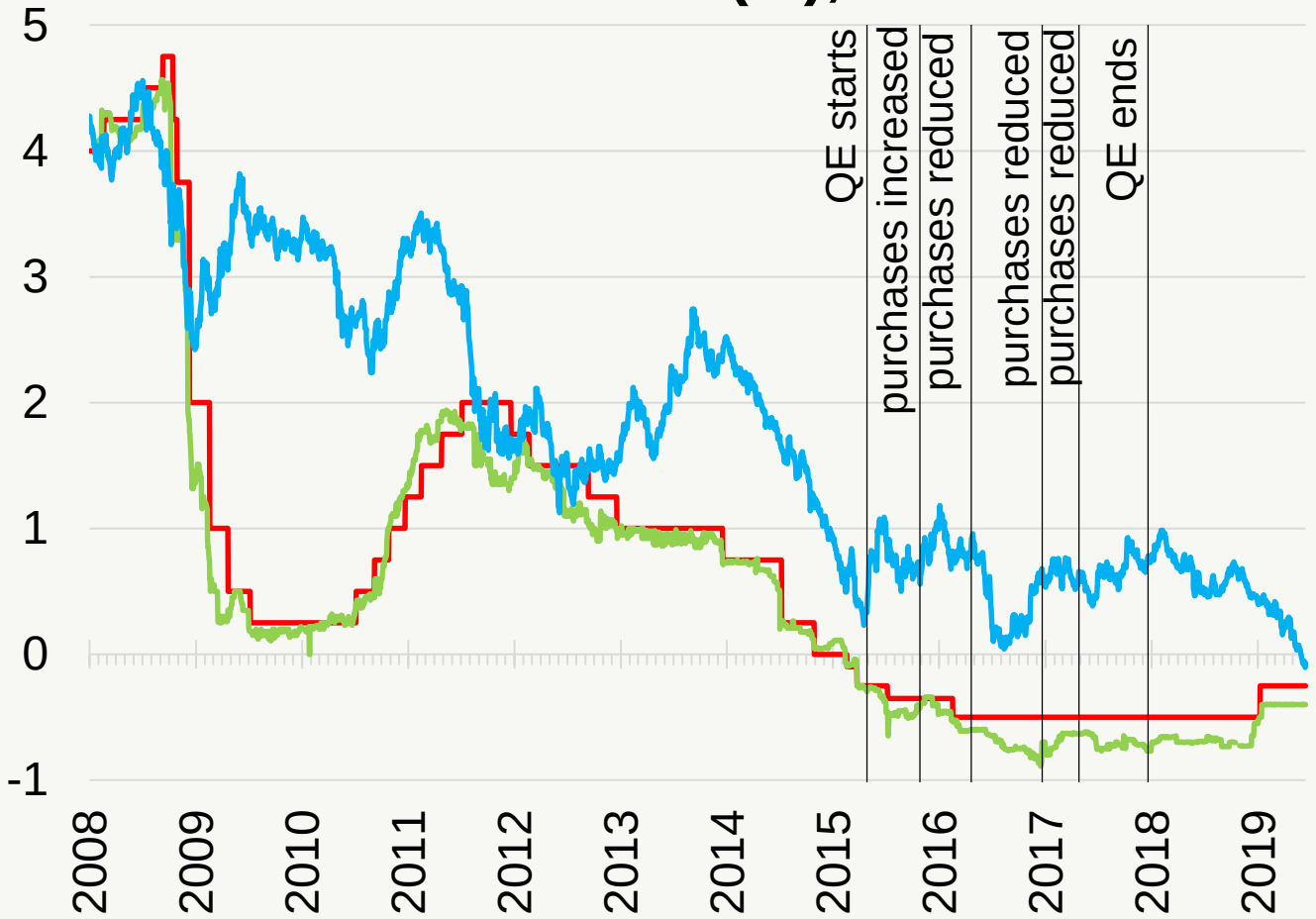
2. Lessons from monetary policy exit mistakes of Sweden, the US and the UK

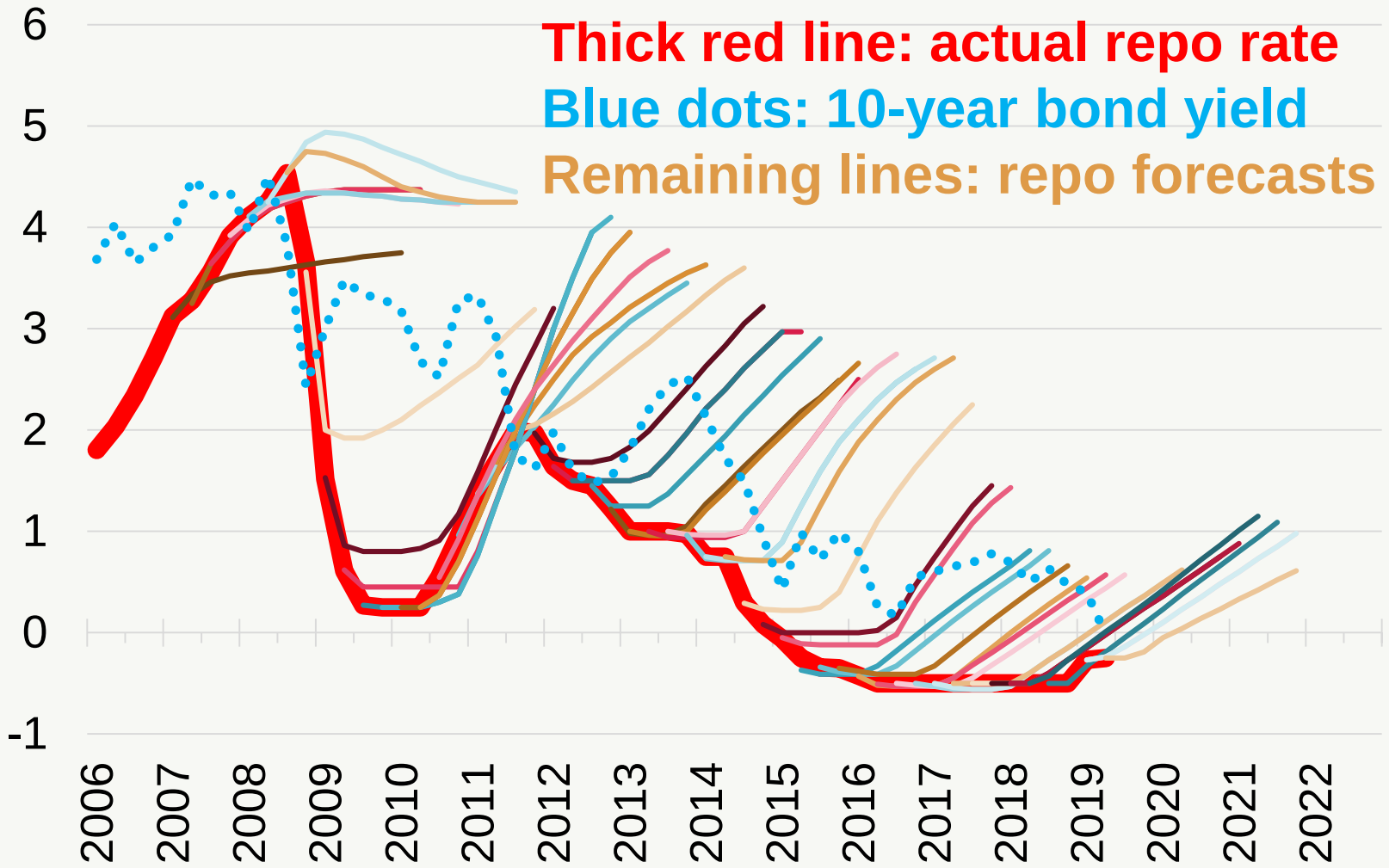
Sweden: premature monetary policy exit followed by massive easing

Swedish interest rates (%), 2 Jan 2008 – 14 June 2019



- The premature 2011 monetary policy exit led to high costs in terms of excessively low inflation, overly high unemployment and a higher real debt burden for households

The Riksbank's repo rate: actual & Riksbank forecasts, and the 10-year gov. bond yield (%)

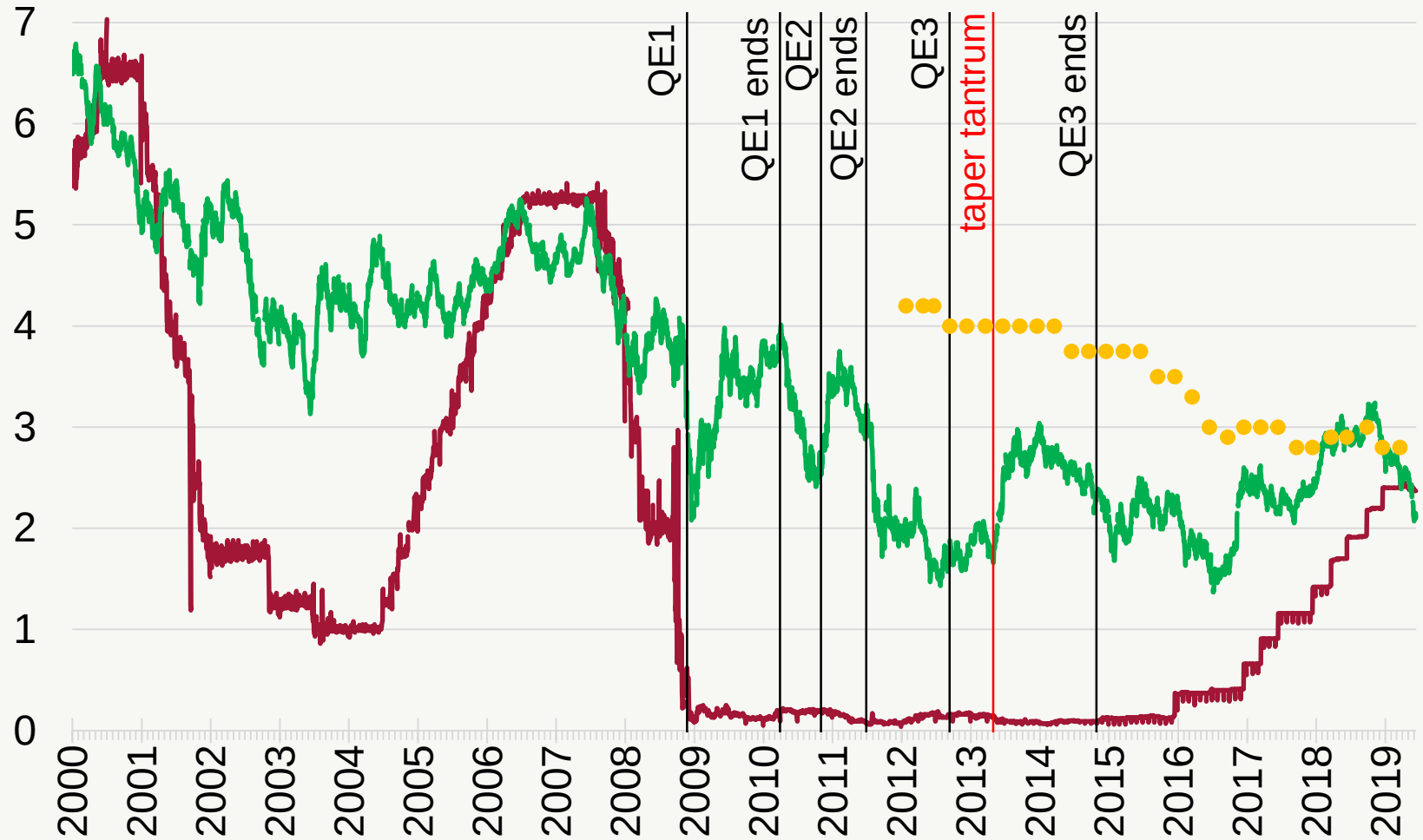


- Apart from the short period around 2010, the Riksbank interest rate guidance turned out to be grossly inadequate
- Noteworthy that recently, the 10-year government bond yield has even fallen despite the Riksbank's interest rate increase forecast and the ending of QE

Federal Reserve: ‘taper tantrum’ unnecessarily pushed-up the 10-year yield

- While QE3 was ongoing in the US, in early 2013 unemployment rate fell to 7.5%, nearing the 6.5% threshold which was announced earlier as the rate when the FED will start increase interest rates
- FOMC started to discuss “tapering” of QE in early May 2013: the 10-year yield increased from 1.7% to 3% in a few months – leading to a far larger tightening in financing conditions than the FED had intended
- Later, the 10-year yield has fallen back even below 1.7%, despite the actual tapering and ending QE and the first increase in federal funds rate in December 2015

US interest rates (%), 2 January 2000 – 14 June 2019

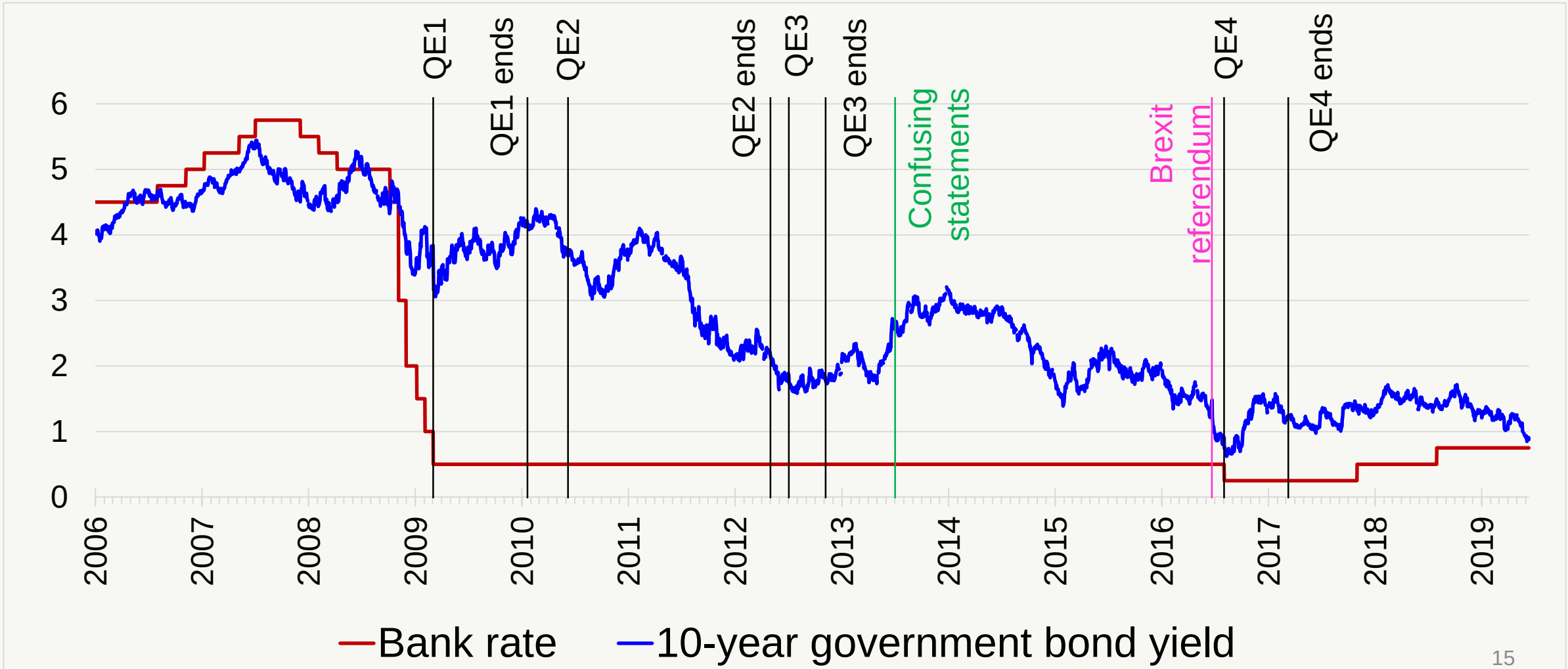


- Federal funds effective rate
- 10-year government bond yield
- Longer-run federal funds rate projection by the FOMC (median)

Bank of England: communication & forward guidance problems unnecessarily pushed-up the 10-year yield

- July 2013: BoE releases a statement (an unusual move in the absence of a policy change) clarifying current policy and questioning whether the expected future rates were in line with economic developments
- Aug 2013: BoE introduces forward guidance, linking increase in interest rate to unemployment falling below 7%
- Feb 2014: BoE updates forward guidance, unlinking it from unemployment following the decrease of the unemployment rate below 7%
- June 2014: Mark Carney suggests that the interest rates could reach 2.5% in early 2017

UK interest rates (%)
2 January 2006 – 13 June 2019



Main conclusions from monetary policy exit experiences of Sweden, US and UK

- Premature exit has to be avoided
- Inappropriate forward guidance could cause non-intended monetary tightening (US, UK)
- Systematically mistaken forward guidance could be disregarded by markets (Sweden)
- Long-term interest rates have not increased when net asset purchases have been stopped; not even after the first few rate increases

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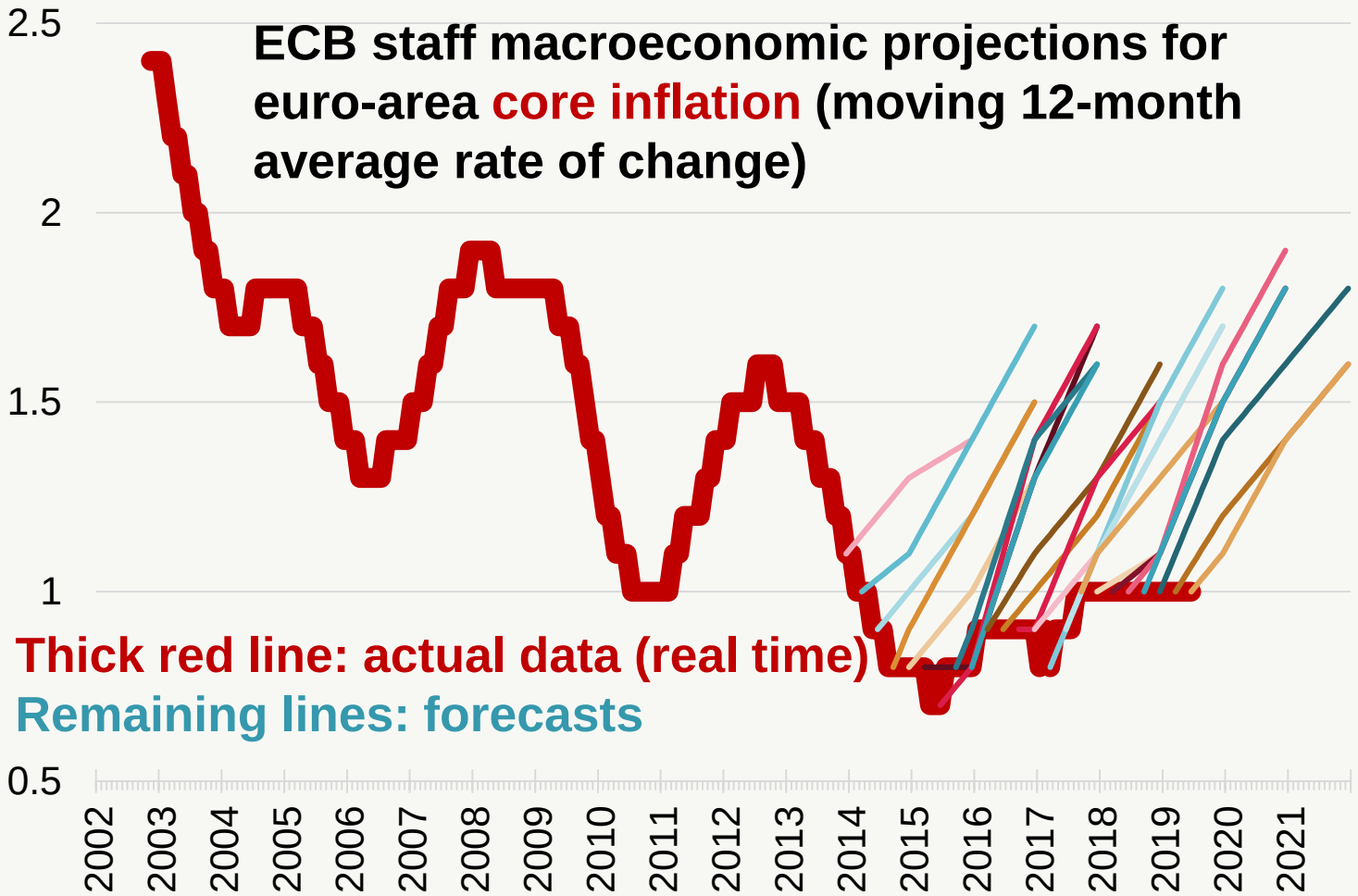
3. ECB Monetary policy exit when the inflation outlook is uncertain

The ECB's core inflation forecast has proved to be overly optimistic. Would it work this time?

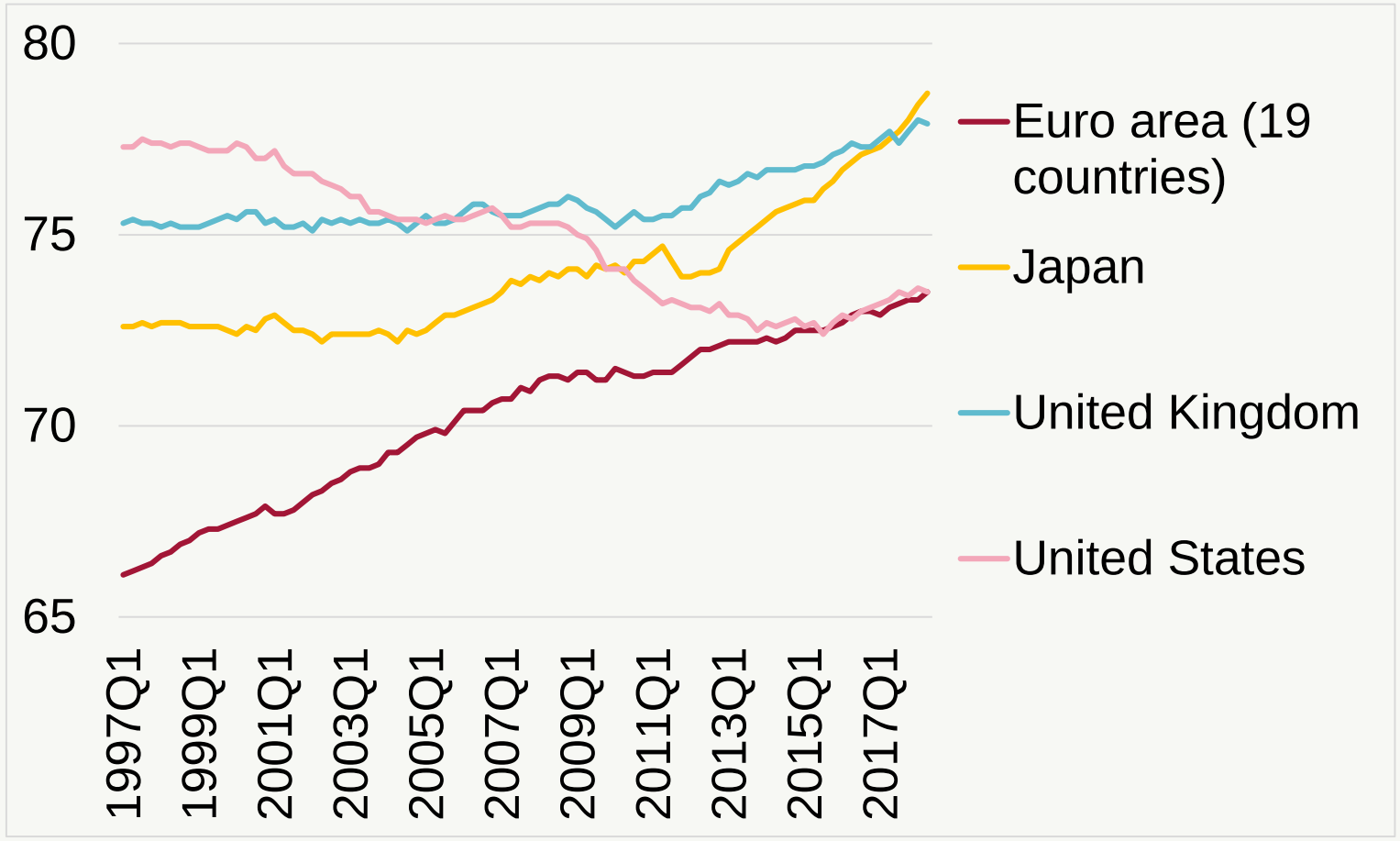


- Despite stubbornly predicting a sizeable increase in core inflation, core inflation is stuck at around 1%

Note: ECB forecasts are available for the annual average inflation. That's why I use the 12 month average rate of change for the actual data, which, in each December, equals annual average inflation. In the chart the December observation of each forecast curve corresponds to the annual average inflation forecast numbers published by the ECB. I have linearly interpolated this December annual average forecast data and the actual inflation rate in the month of the date of the forecast.

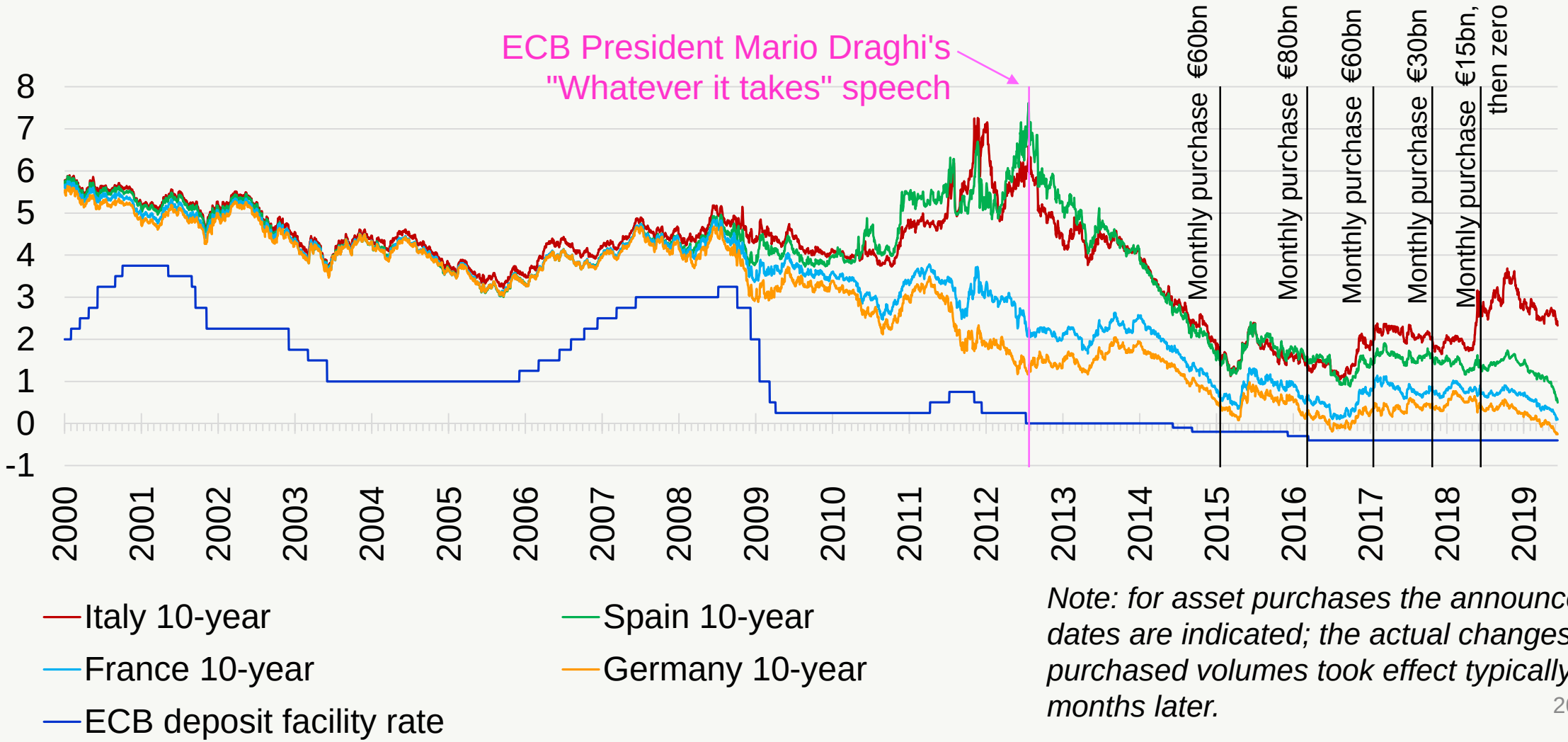
Labour force participation continues to expand – good news for the people, bad news for inflation

Labour force participation rate (age 15-64, % of population)



- While Americans were fleeing the labour market in 2000-2015, there has been a steady increase in euro area labour force participation

ECB deposit facility interest rate and 10-year government bond yields of four countries (%) 4 January 2000 – 14 June 2019

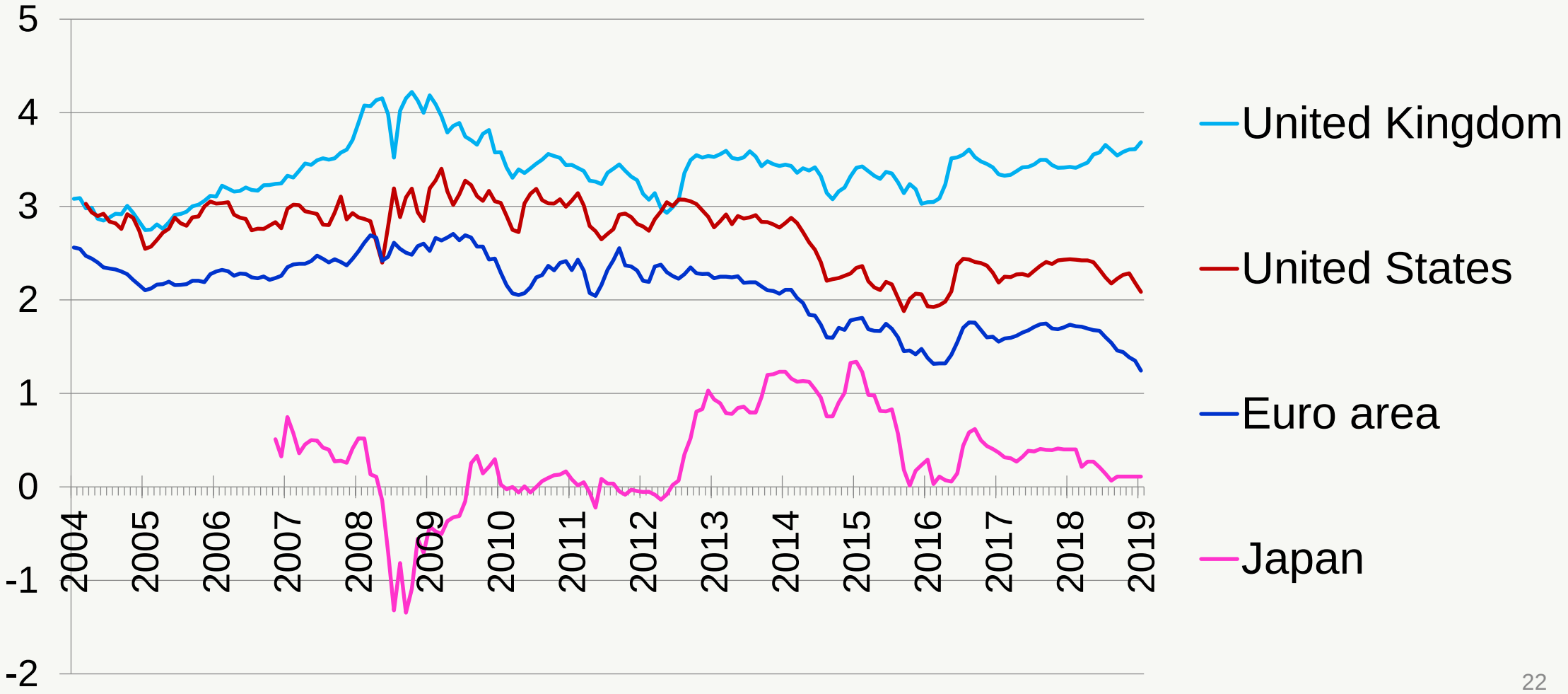


Note: for asset purchases the announcement dates are indicated; the actual changes to purchased volumes took effect typically about 2 months later.

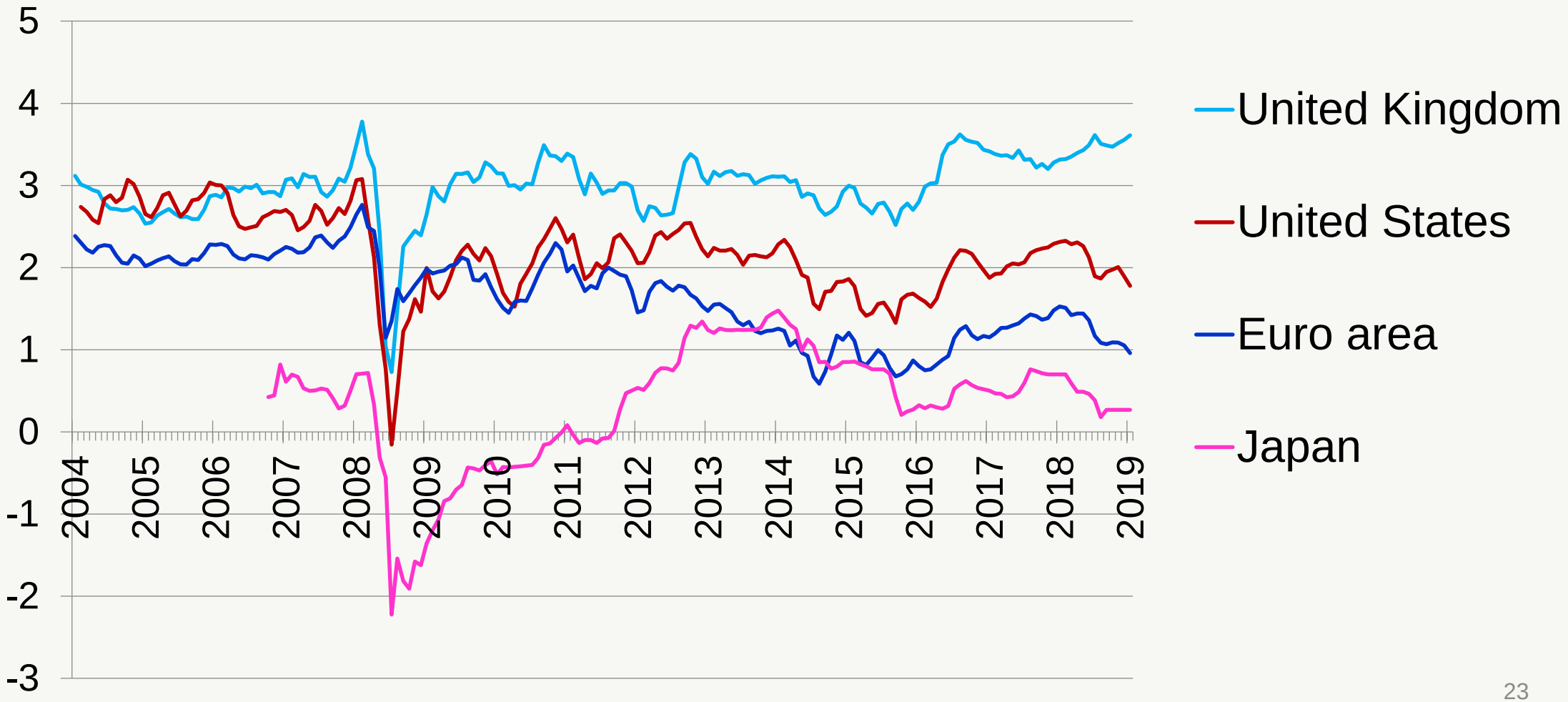
ECB monetary policy normalisation

- Deteriorating economic outlook
- Inability to lift core inflation and systematic forecast errors undermine ECB credibility (see next two charts)
- Text of ECB press release has hardly changed:
  - "*The Governing Council now expects the key ECB interest rates to remain at their present levels at least through the first half of 2020, and in any case for as long as necessary to ensure the continued sustained convergence of inflation to levels that are below, but close to, 2% over the medium term.*" (6 June 2019 ECB press release)
- What's needed: more time, more monetary stimulus or a new inflation target?

Market-based five-year average headline inflation expectations in the next five years, January 2004 – June 2019



Market-based five-year average headline inflation expectations in the five years starting in five years' time, January 2004 – June 2019



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4. Monetary policy and financial stability

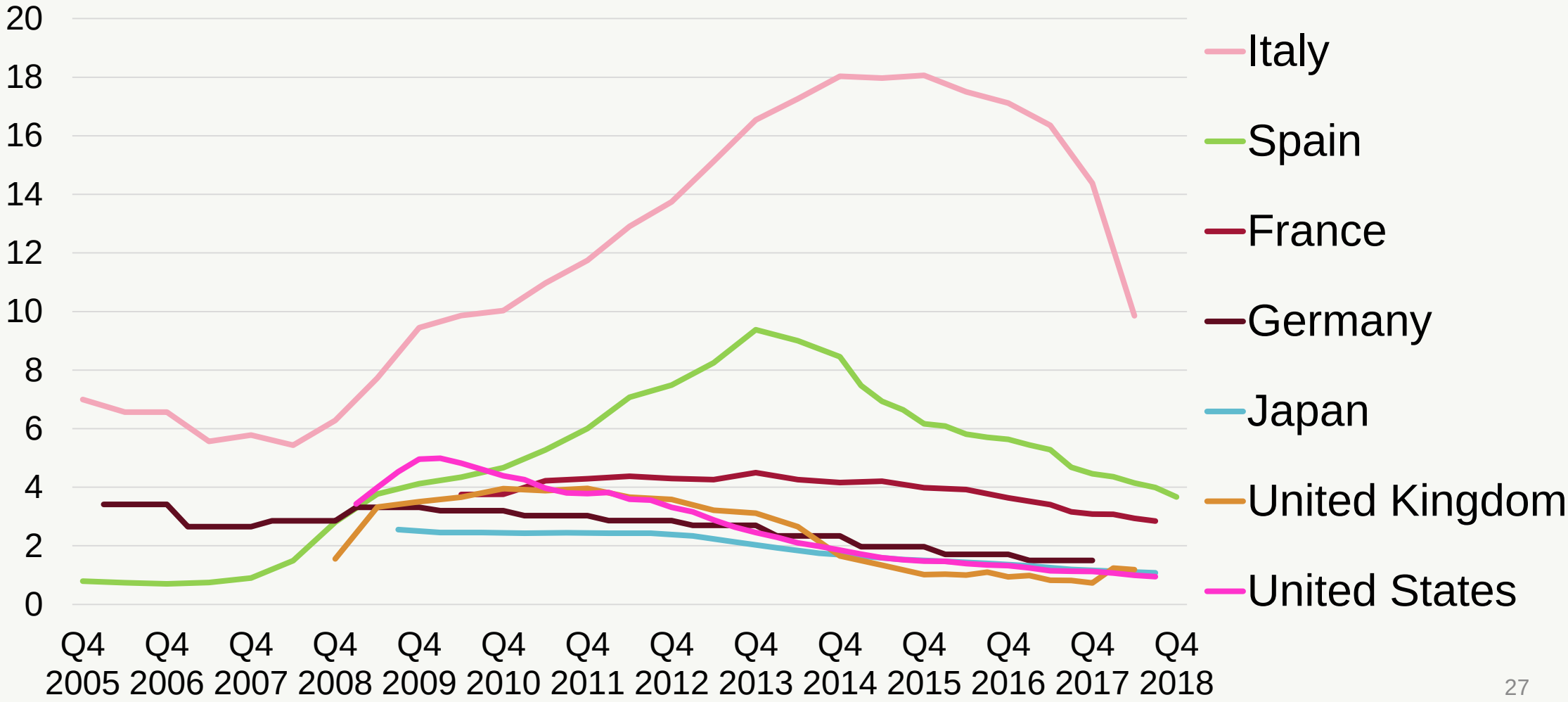
Financial stability risks

- Low interest rates can:
  - Encourage ‘excessive’ risk taking
  - Encourage bank lending to less credit-worthy customers
  - Increase the leverage of the corporate sector
  - Create asset price bubbles (e.g. stock market and housing)
  - Worsen banks’ profitability
- Monetary policy normalisation can:
  - Increase defaults
  - Burst bubbles
- Spillovers from advanced to emerging/developing countries

Evidence for the euro area

- Darvas and Pichler (2018):
  - Some house price increases, but not comparable to earlier housing boom periods
  - House price increase not boosted by credit growth (except Slovakia and Belgium)
  - Difficult to identify bubbles
- ECB Financial Stability Review (May 2019):
  - Return of search for yield
  - Euro area banks struggle with low return on equity (share of non-performing loans still higher than in the US, overcapacity, low cost-efficiency)
  - Expected default frequencies of European (and also US) non-financial corporations are relatively low

Non-performing loans to total gross loans (%)



Should monetary policy aim to support financial stability?

- There are strong interactions between monetary policy and financial stability policy
- However, the interest rate (the main monetary policy instrument) is too broad and ultimately quite ineffective in dealing with the build-up of financial imbalances
- Problem is even more severe in the heterogeneous euro area
- Macroprudential policy should play a major role
- In several euro area countries certain vulnerabilities have already led to measures, like capital buffer for systemically important institutions, countercyclical capital buffers, debt-to-income ratio limits and loan-to-value ratio limits

Five main take-aways

1. The natural rate of interest might remain low, constraining monetary policy
2. Premature monetary policy exit involves major risks, while inadequate forward guidance could cause market turbulence
3. The inflation outlook in the euro area is very uncertain: more time, more stimulus or a new inflation target?
4. Monetary policy is unsuitable for addressing financial stability concerns; instead, macroprudential policy should have a major role
5. The large heterogeneity of the euro area makes the use of monetary policy for financial stability even less effective

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Thank you for your attention

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