IMFS WORKING LUNCH

INFLATION TARGETING AND FINANCIAL STABILITY: MONETARY POLICY CHALLENGES FOR THE FUTURE

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01 SOME REFLECTIONS ON THE SECULAR DECLINE IN INTEREST RATES
a) Fundamental Factors
b) The Impact of Monetary Policy

02 HAS MONETARY POLICY HAD AN IMPACT ON GROWTH AND INFLATION?
  a) A weak Credit Channel in the Balance Sheet Recession
  b) Monetary Policy pushes up Asset Prices, but does this have a lasting effect?
  c) The Phillips Curve has become rather weak

03 A SIDE EFFECT OF MONETARY ACCOMMODATION: THE RISK OF SERIAL BUBBLES AND EXCESSIVE LEVERAGE

04 POLICY CHALLENGES AND PROPOSALS FOR CHANGE
  a) Recalibrating Inflation Targets
  b) Accounting for Trade-Offs with Financial Stability and leaning against the wind

05 THE RISKS OF QE AS THE NEW NORMAL
CHART 2.1 – THE SECULAR DECLINE OF BOND YIELDS IN ADVANCED ECONOMIES

10-year government bonds, nominal yields

10-year government bonds, real yields*

* Nominal rates adjusted for Consumer Price Inflation

Source: Thomson Reuters Datastream, OECD, ECB
CHART 2.2 – SHIFTS IN OECD AGE DISTRIBUTION

Source: UN, Department of Economic and Social Affairs. World Population Prospects
Japan: It is the only large country that presents a secular decline in the savings rate. Its population has been slowing since the mid-1970 and the ageing of the society set in earlier and more forcefully compared to other countries. The growing number of elderly Japanese has an average lower saving rate than active workers and partly even draw down their wealth – a reminder of how much demography effects savings and how the retirement of baby boomers will decline our saving rate, particularly in the years after 2020.
CHART 2.6 – SHIFT IN SAVINGS AND INVESTMENT CURVE

Right shift in savings curve:
- Emerging markets
- Demography
- Income distribution

Left shift in investment curve:
- Uncertainty
- Deleveraging
- Decline in public-sector investment
- Falling relative price of investment goods

$r = \text{real interest rate (global equilibrium interest rate)}$
CHART 2.7 – INVESTMENT RATIOS IN INDUSTRIALIZED COUNTRIES

Gross investment, all sectors (in relation to GDP)

Gross investment from corporates
(in relation to GDP)

Source: World Bank

Source: Eurostat / HIS
### Chart 2.8 – Where Are Global Real Interest Rates Heading in the Long-Term?

<table>
<thead>
<tr>
<th>Driving factors</th>
<th>Impact on real interest rate: slightly up</th>
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<tbody>
<tr>
<td>Shift in saving curve</td>
<td></td>
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<tr>
<td>• Demography: rising proportion of older people</td>
<td>Upward</td>
</tr>
<tr>
<td>• Lower savings in emerging markets</td>
<td></td>
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<tr>
<td>Shift in investment curve</td>
<td></td>
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<tr>
<td>• Pressure from private sector deleveraging eases</td>
<td>Slightly upward</td>
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<tr>
<td>• Public-sector investment rises slightly</td>
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<tr>
<td>• Importance of intangible investment remains high</td>
<td></td>
</tr>
<tr>
<td>Portfolio shifts</td>
<td></td>
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<tr>
<td>• Little change of regulatory preference for government bonds</td>
<td>Unchanged?</td>
</tr>
<tr>
<td>• Preference for safe assets on the side of investors remains?</td>
<td></td>
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<tr>
<td>Productivity growth</td>
<td></td>
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<tr>
<td>• Positive impact of information and communication technology</td>
<td>Slightly upward</td>
</tr>
</tbody>
</table>
CHART 2.10 – ECB BALANCE SHEET STRUCTURE

Eurosystem Assets (EUR bn)

Source: Allianz Research
CHART 2.11 – GERMANY: BOND YIELDS UNDERSHOOT NOMINAL GDP GROWTH

* Yield on bonds outstanding 9-10 year government bonds. 2017: Average January – June.
** Prior to 1991: territory of the former federal republic; 2017: Allianz Research forecast

Source: OECD, Destatis, Allianz Research
CHART 2.12 – TEN-YEAR EURO-AREA BOND YIELDS AND THE TERM PREMIUM

10-year term premia estimates: EU vs US (%)
(January 2013 – September 2017)


Source: ECB, Benoît Coeuré: „Monetary policy, exchange rates and capital flows”

Euro-area bond yield and components *
(January 2014 - April 2017)

Notes: Decomposition of the 10-year nominal yield according to an estimated joint macroeconomic and term structure model; see P Hördahl and O Tristani, „Inflation risk premia in the euro area and the United States”, International Journal of Central Banking, September 2014. Yields are expressed in zero coupon terms, for the euro area, French government bond data is used.

Source: Bank for International Settlements, Annual Report 2017
CHART 2.13 – ESTIMATED QE IMPACT ON 10-YEAR GERMAN GOVERNMENT BOND YIELDS (MAR 2015 TO JAN 2018)

Source: ECB, Own calculations
Monetary base, money supply (M2), bank lending and inflation in Japan

(Oct 1997 = 100)

- Monetary base
- Money Supply (M2)
- Aggregate bank lending (excl. Shinkin banks)

Quantitative easing

Earthquake

Core consumer price inflation

Oct. 97

Source: Datastream, Allianz Research
CHART 3.2 – MODERATE INCREASE OF BANK LENDING DESPITE QUANTITATIVE EASING IN THE US

Monetary base, money supply, bank lending and inflation in the US
(Aug 2008 = 100)

Source: Datastream, Allianz Research
CHART 3.3 – WEAK EUROZONE BANK LENDING DESPITE BALANCE SHEET EXPANSION BY THE ECB

Monetary base, money supply (M2), bank lending and inflation in the EMU
(Aug 2008 = 100)

Source: Datastream, Allianz Research
CHART 3.4 – HOW VALUATION GAINS IMPACT FINANCIAL WEALTH

Contribution of market valuations to financial asset growth

Source: National Central Banks and Statistical Offices, Allianz Research
CHART 3.5 – HOUSE PRICE INDEX USA

Source: All transactions House Price Indices for the U.S.,
U.S. Federal Housing Finance Agency
CHART 3.6 – HOUSE PRICE INDEX EUROPE

Source: House Price Index (2015 = 100) - quarterly data, Eurostat; Consumer Price Inflation (2015 =100) – quarterly data, FRED
CHART 3.7 – BALANCE SHEET VULNERABILITIES

Quality Breakdown of Investment-Grade Index
(Percent of index with BBB ratings)

Source: IMF, 2018* Data from the IMF Debt Database as presented in IMF Global Financial Stability Report 2018
Corporate bond portfolios of asset managers show a declining share of high quality bonds and more risks in their portfolios for the euro area. If and when the macroeconomic outlook worsens and investors become more risk averse, the value of lower quality bonds will decline disproportionately. Hence, the positive effect of asset prices on consumer and investment demand will turn strongly negative and amplify the economic slowdown. The same can happen, if the interest rate outlook changes and central banks become more hawkish, whereby the return on safe bonds will rise while markets for lower quality assets suffer.
CHART 3.9 – ECB POLICY MEASURES AND THE HARMONIZED INDEX OF CONSUMER PRICES

CBPP: Covered Bond Purchase Programme (July 2009)
SMP: Securities Markets Programme (May 2010)
OMT: Outright Monetary Transactions (Sept 2012)
APP: Asset Purchase Programme (22. Jan 2015)

Source: Harmonized Index of Consumer Prices (HICPI), monthly data (annual rate of change), Eurostat.
CHART 4.3 – NOMINAL TOTAL RETURN BY INCOME GROUP

Average 2012 to 2017

Source: ECB: The Eurosystem Household Finance and Consumption Survey, Allianz Research
CHART 4.5 – TARGET II (IM) BALANCES RISE TO EVER HIGHER LEVELS

Eurozone Target II Balances, EUR bn

Source: Thomson Reuters Datastream, Allianz Research
CHART 4.6 – INTER-BANK LENDING SQUEEZE IN THE EUROZONE

Cross-border bank lending within the Eurozone, loans & debt securities, MFIs, outstanding amounts in EUR bn

Source: ECB, Allianz Research
CHART 4.7 – FED POLICY AND THE CYCLE

Burst of the Dot-Com bubble  Lehman Collapse

Source: Yield of ten year treasuries - Federal Reserve Economic Data, Federal Reserve Bank of St. Louis
CHART 4.8 – DELEVERAGING. WHAT DELEVERAGING?

World non-financial debt, public and private, as % of GDP

Source: Allianz GI, BIS, data as at 2Q 2017, analysis based on G20 countries
POLICY CHALLENGES AND PROPOSAL FOR CHANGE

a) Recalibrating Inflation Targets

• Central Banks could start by defining price stability targets (whether implicit or explicit) in a more adaptable way.

Three options:
• Extension of number of years in which inflation target must be reached to deviate from the reference value for consumer price inflation for a longer time if needed.
• Defining ranges of inflation that are more easily compatible with price stability.
• Defining the target of protecting monetary stability more broadly.

→ Widen the definition of price stability targets and move the focus away from a simple year-on-year target for consumer price inflation.

b) Accounting for Trade-Offs with Financial Stability and leaning against the wind

• Loosened monetary and financial conditions are warranted during weak economic growth, but can create risks for future growth after long economic upswings, as investors become less risk averse due to high valuations and low volatility. Loose financial conditions become a symptom of complacency, rather than stability.
• Smoothing the financial cycle by “leaning against the wind” approach improves economic performance in the long run, The ECB’s two pillars are a useful framework for such a policy.
• Emphasizing the second pillar does not implicate a complete overhaul of ECB’s policy approach, rather a rebalancing based on a broad set of financial cycle indicators.
• Macroprudential policy cannot neutralize the financial market impact of monetary policies.
CHART 5.1 – SUGGESTION FOR AN INFLATION INDICATOR

**Building a broader Index of Price Stability:**
Deviations of such an index from the ECB’s reference value of “below, but close to 2%” are much less pronounced than those of the year-on-year change in headline inflation rates. Credibility of central banks could be enhanced by using a target definition with different important elements of inflation.

Source: Thomson Reuters Datastream, Allianz Research
Judging by the IMF’s index, financial conditions have been loose for a number of years and tightened only slightly since the Fed has begun decreasing the degree of accommodation in its policies. Additionally, the index shows that financial conditions are typically very loose in advance of major market corrections, most notably in the run-up to 2008.