Institute for Monetary and Financial Stability

Some thoughts on unconventional monetary policy and the “new normal”

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Unconventional monetary policy measures – the “new normal”: Questions to panelists

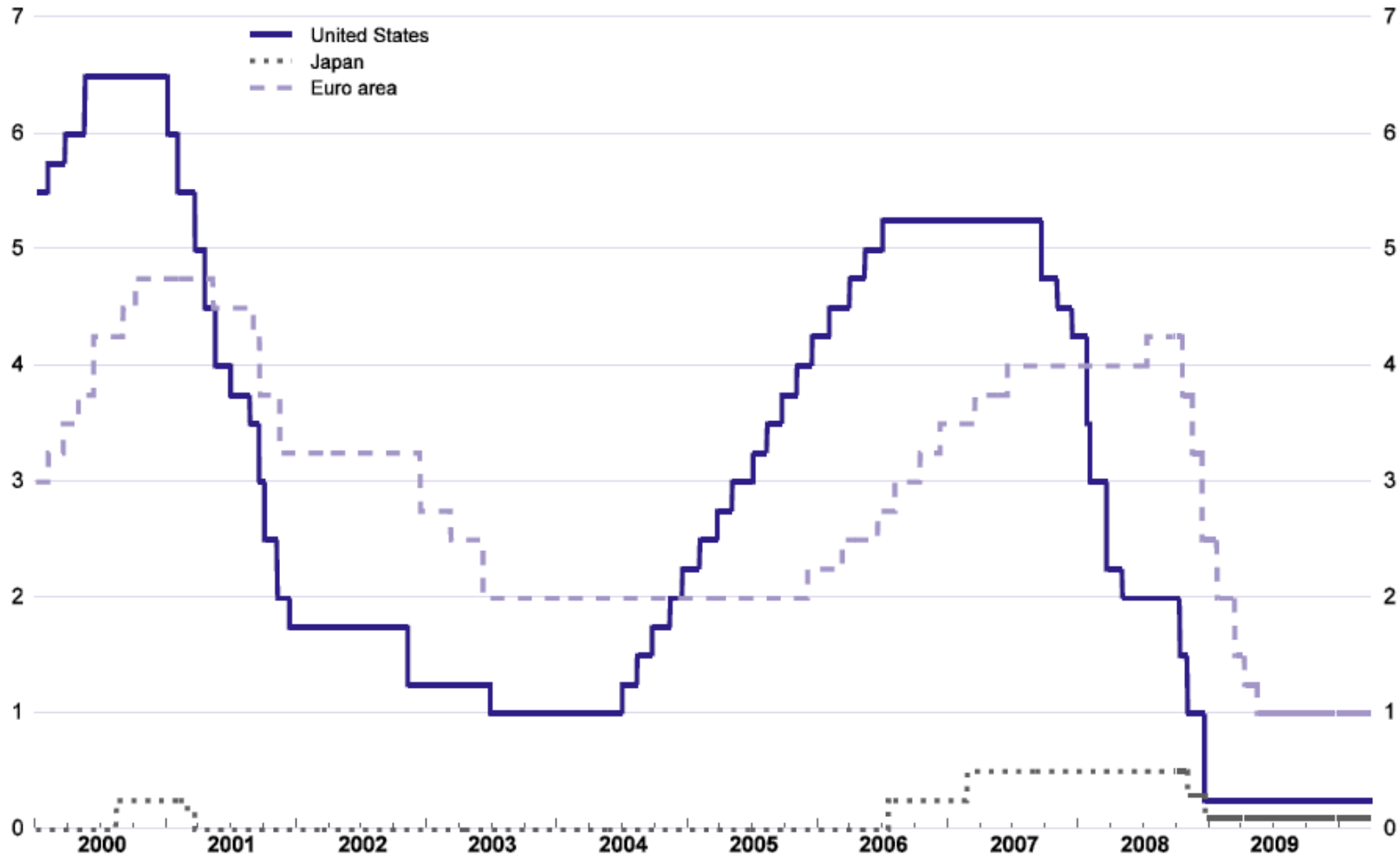
- Monetary policy in the world of a “new normal”: Do we need to reconsider existing monetary policy frameworks?
- How effective have the monetary policy measures been in the course of the crisis?
- What are potential (long-run) risks of these measures?
- What will be the downsides of the (inevitable) exit from the unconventional policy measures? How can it be managed to minimize the foreseeable negative effects?
- Which competences and powers does a central bank need in the times of a “new normal”?

Some thoughts on

1. Near zero interest rates and quantitative easing
2. Quantitative easing versus SMP and OMT
3. Forward guidance on interest rates: “Disclosure of reaction function” vs “lower for longer”
4. Exit from near zero interest rates: Traps and risks

1. Near zero interest rates and QE

1.1. Joining Japan



- Central bank rates 2000-2009: US, Japan, Euro area

1.2. The new normal?

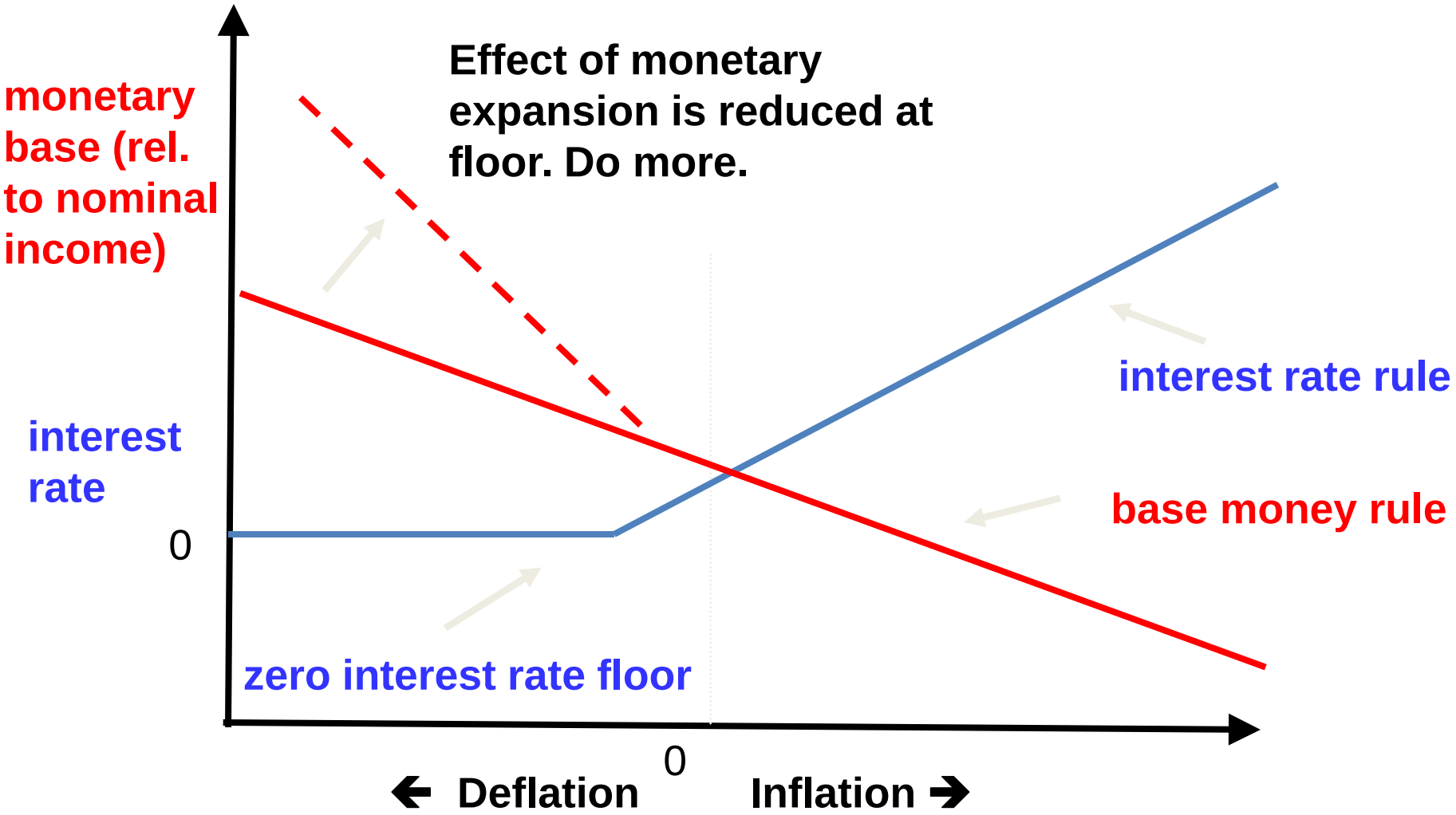
Source: The Economist, Apr 6th 2013.

1.3. QE – Continuation of standard policy with other means …

J.C. Trichet, November 2010. *There are two distinct views on non-standard measures. Some view them as the continuation of standard policy by other means. Once nominal interest rates cannot be lowered further, central banks use other tools to determine the monetary policy stance – that is, to contribute in the desired way to economic, financial and monetary developments in pursuit of price stability.*

Footnote: For a discussion, see Orphanides and V. Wieland (2000), "Efficient monetary policy design near price stability", Journal of the Japanese and International Economies .

1.4. New operating target: Base money expanded by asset purchases



1.5. Trichet 2010 continued

Figuratively speaking, this can be compared to – once the end of the road has been reached – engaging the four-wheel drive. The logic .. is .. sequential.

***At the ECB, we have a different view**. We set our key interest rates at levels .. appropriate to maintain price stability, … But on several occasions, the monetary policy stance .. faced obstacles in being transmitted to the .. economy.*

Staying with the image of the road, ... we sought to remove the major roadblocks in front of us, so that our policy stance could be transmitted to the economy in the intended way.

*The logic .. is .. parallel: … **implications for the exit: .. we can determine standard and non-standard measures largely independently.***

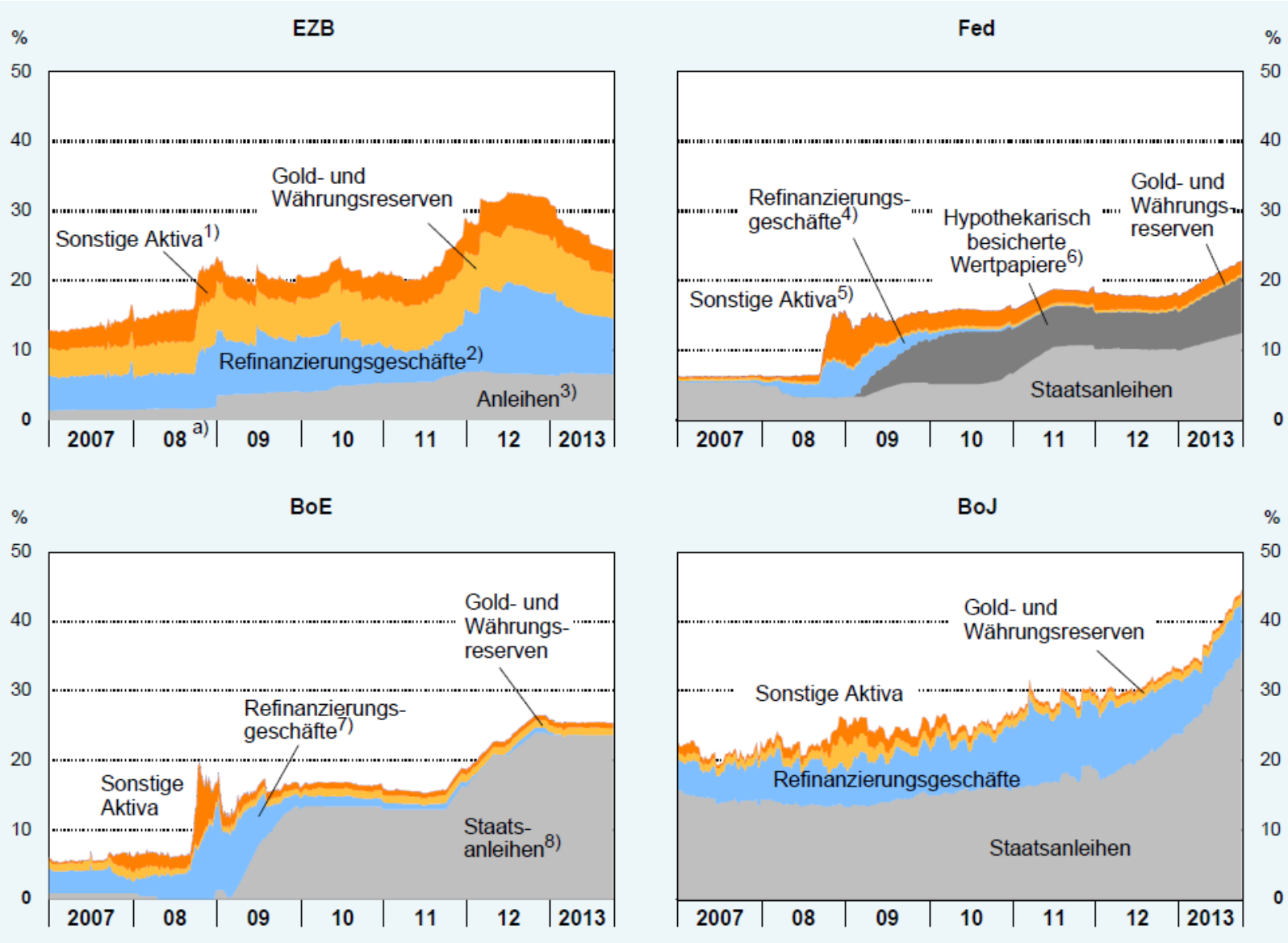
2. Quantitative Easing versus SMP and OMT

2.1. QE for the Eurozone?

- Martin Feldstein, James Bullard and others: ECB could mirror QE as conducted in nation states by purchasing debt of **all** euro zone member governments according to GDP weights.

- ECB expanded base money and central bank balance sheet quite effectively via long-term repos.

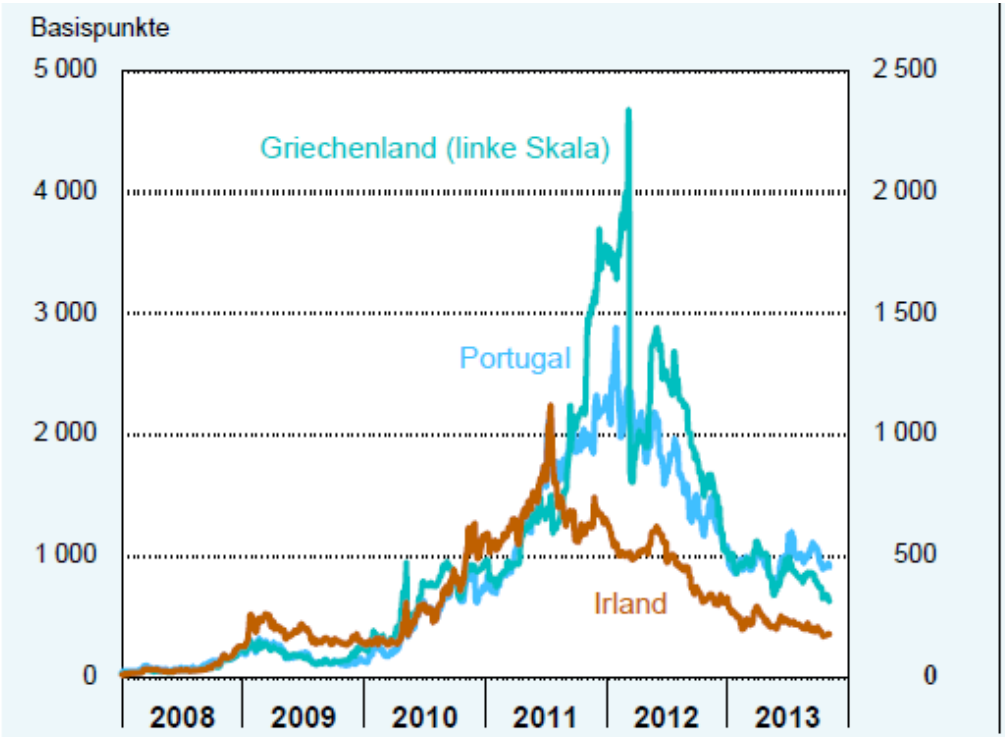
2.2. Central bank balance sheets (% nom.GDP)

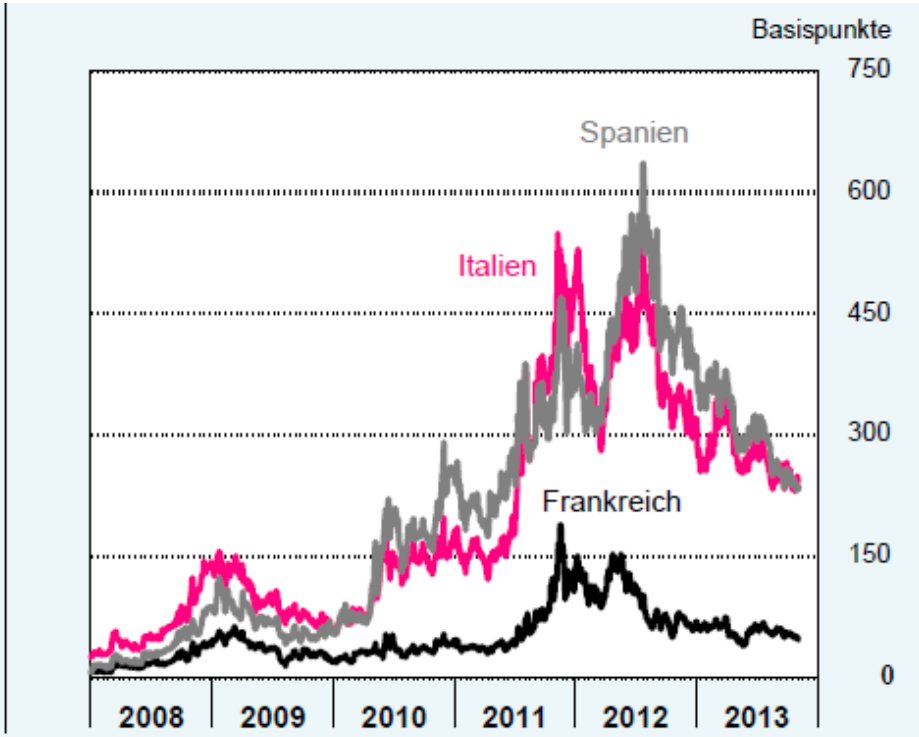


2.3. QE versus SMP and OMT

- **QE:** Response to (threat of) deflation. Reduce term and risk premia.
- **SMP/OMT:** Response to € sovereign crisis. Reduce government bond spreads by buying selectively.
- **OMT announcement**: Take on default risk by giving up seniority status. Conditionality via ESM program.
  - Effective reduction of sovereign spreads.
  - Risks: Lower incentives for fiscal consolidation and reform. Increase in government debt on bank balance sheets.

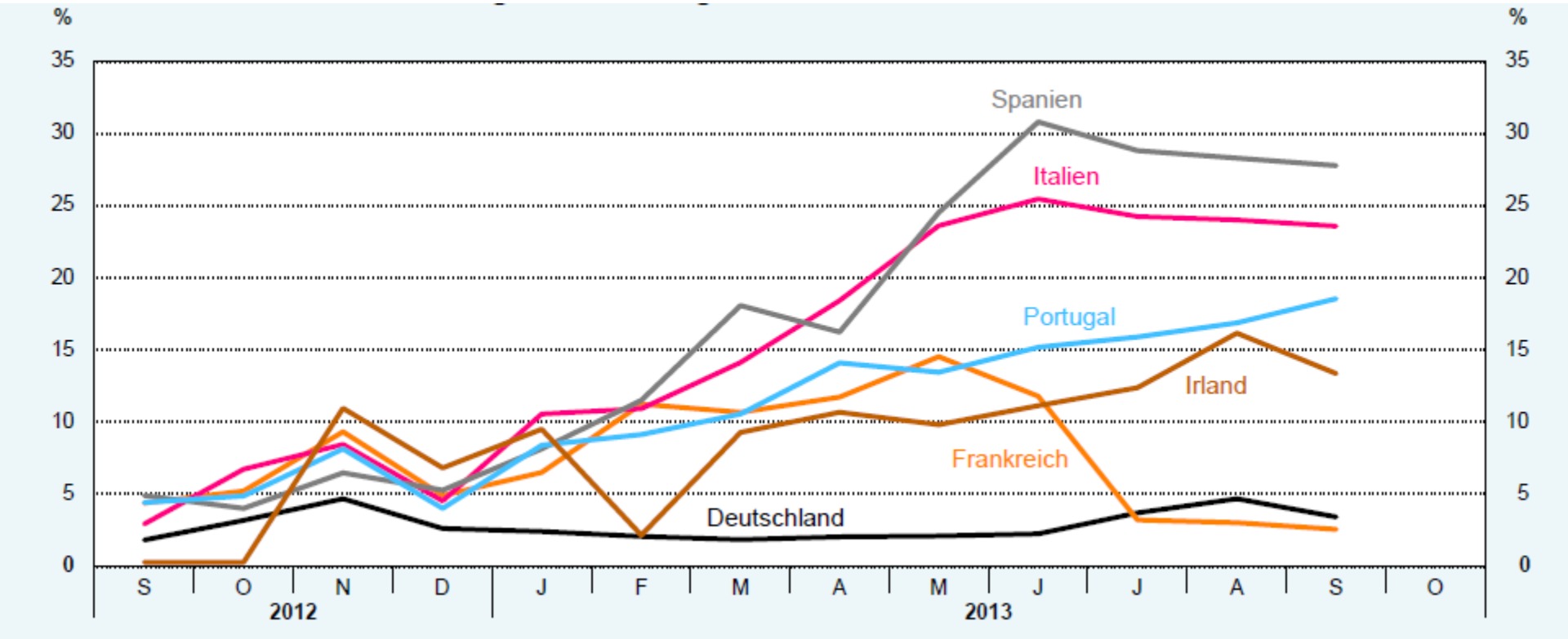
2.4. Peak of Italian and Spanish bond yields just before OMT Annoucement (Aug 2012)





Sovereign spreads vis-a-vis German government debt (10-year bonds). Spain (grey), Italy (red).

2.5. % Increase in banks' holdings of public debt following OMT announcement



Spain (grey), Italy (red), Portugal (blue), Ireland (brown), France (orange), Germany (black).

3. Forward guidance on interest rates

3.1. “Regular reaction” vs “lower for longer”

- Near zero asymmetry of possible rate changes may create upward bias in longer-term rates (absent QE): probabilty of rate cut zero, but positive for rate hike.
- Stronger case for managing expectations of future rates ➔ forward guidance.
- Approach 1: reveal more information about central bank forecast of its own future rate decisions.
- Approach 2: announce that interest rates will be kept lower for longer relative to historical policy reaction (Reifschneider-Williams 2000, Woodford 2012).

3.2. ECB: own forecast of rates and "internal" reaction function

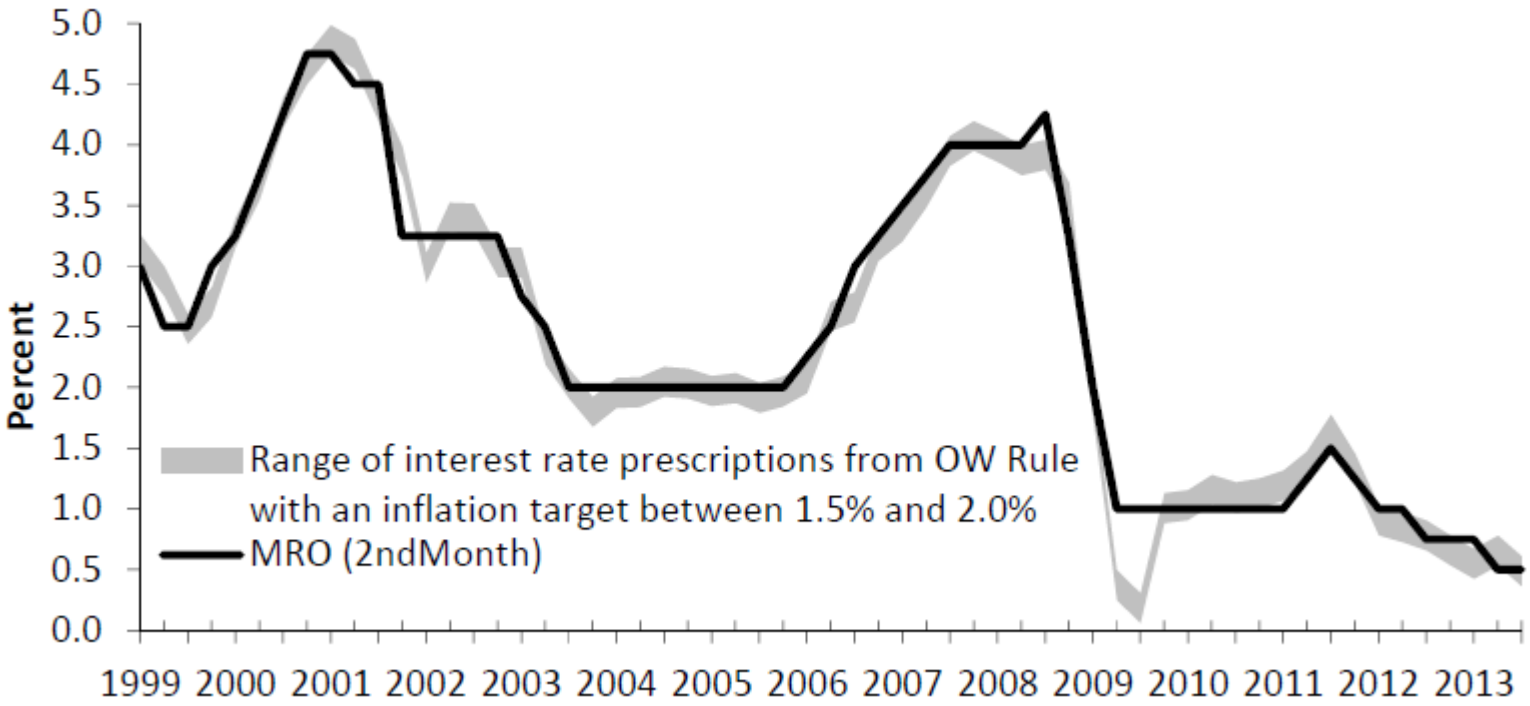
M. Draghi on July 4, 2013: "*The Governing Council* ***expects*** *the ECB interest rates to remain at present or lower levels for an extended period of time.* ***This expectation*** *is based on the overall subdued outlook for inflation extending into the medium term, given the broad-based weakness in the real economy and subdued monetary dynamics.*"

M. Draghi: "*there is no precise deadline for this extended period of time. As a matter of fact, you can …* ***extract a reaction function and, from there, estimate what would be a reasonable extended period of time***".

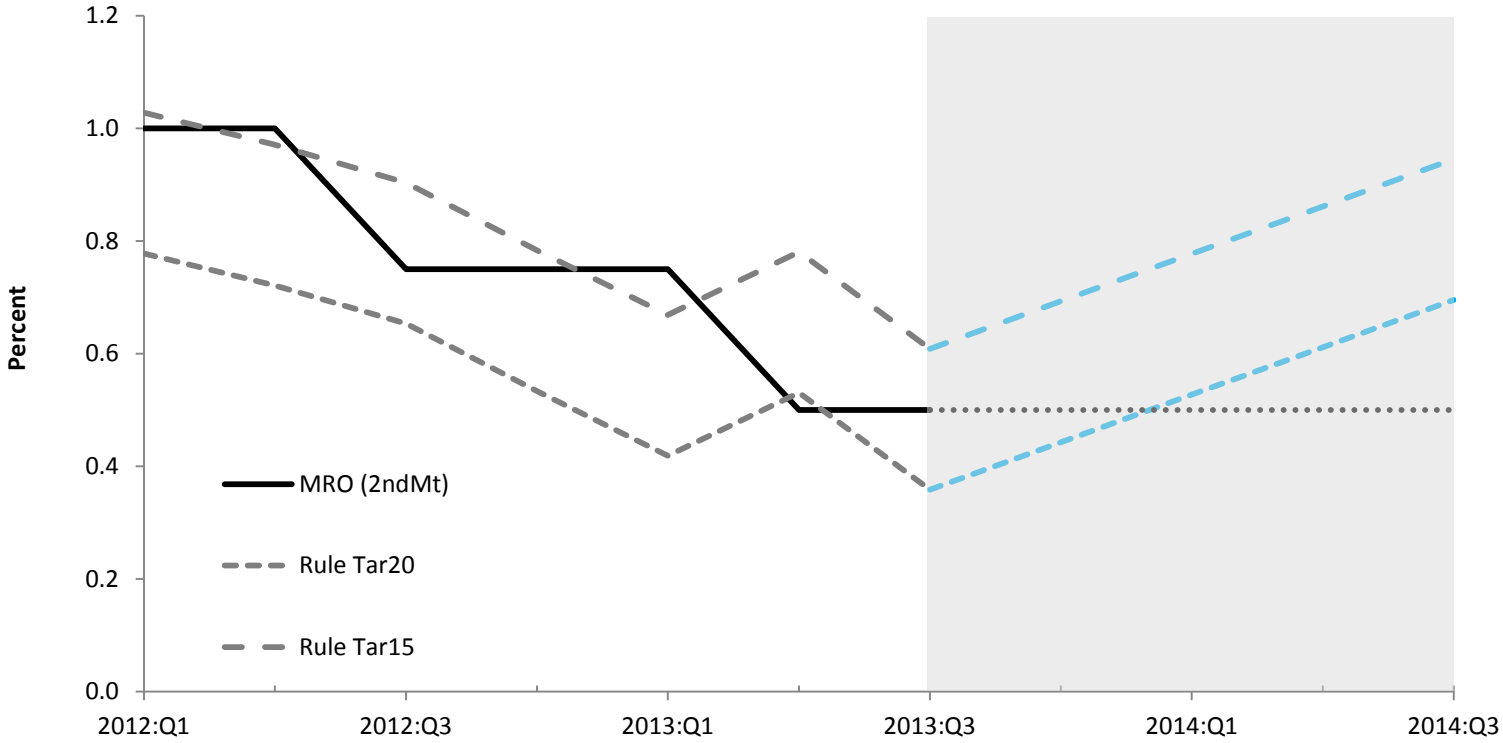
3.3. An example of a reaction function: (Orphanides-Wieland 2013)

$$i_t - i_{t-1} = 0.5(\pi_{t+3|t} - \pi^*) + 0.5(q_{t+2|t} - q^*_{t+2|t})$$

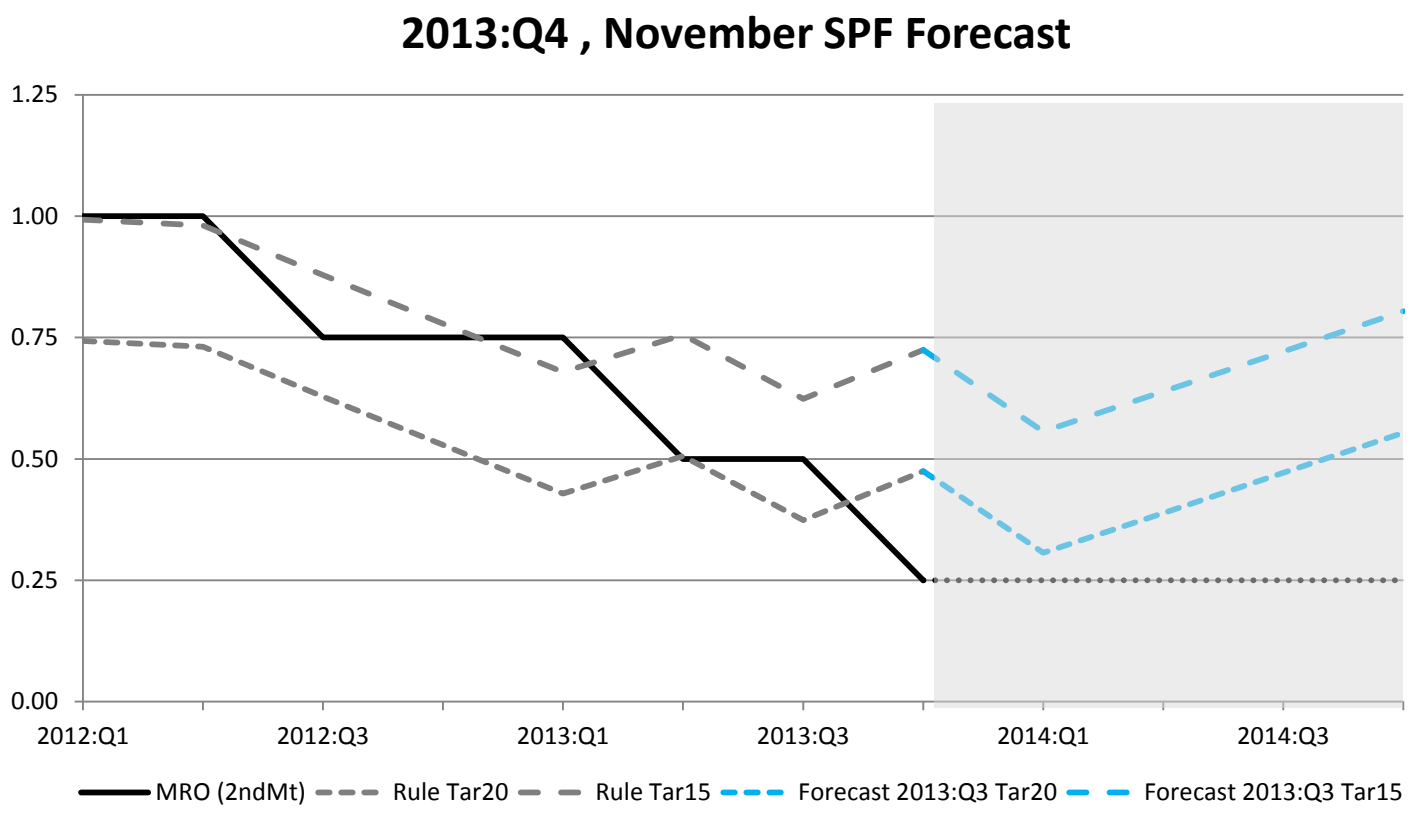
Figure 1: MRO Rate versus Orphanides and Wieland (2013) Rule with SPF Forecasts



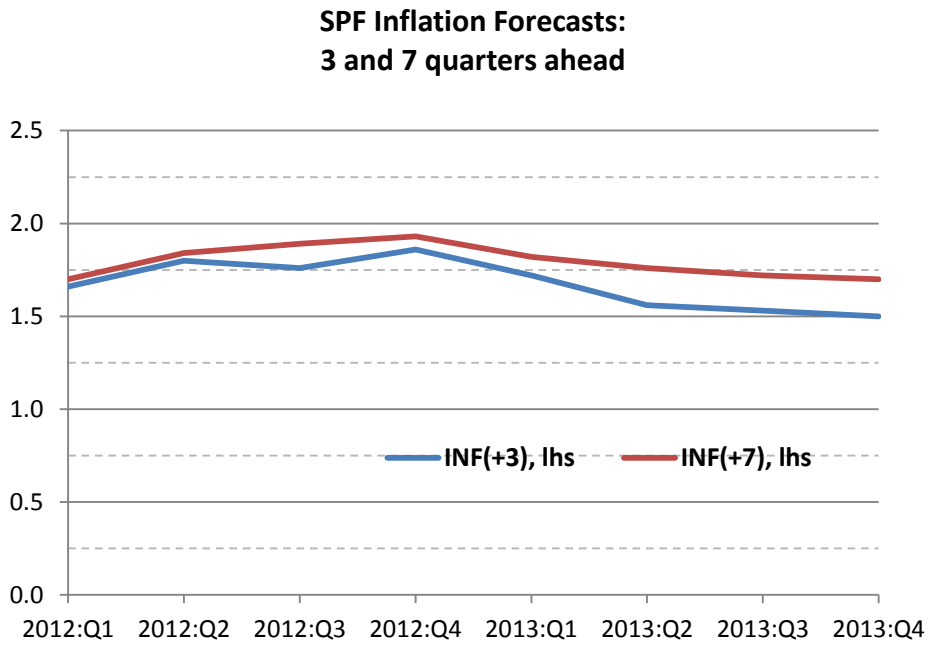
3.4. Projected rate hike based on August 2013 SPF Forecast: Q3 2014

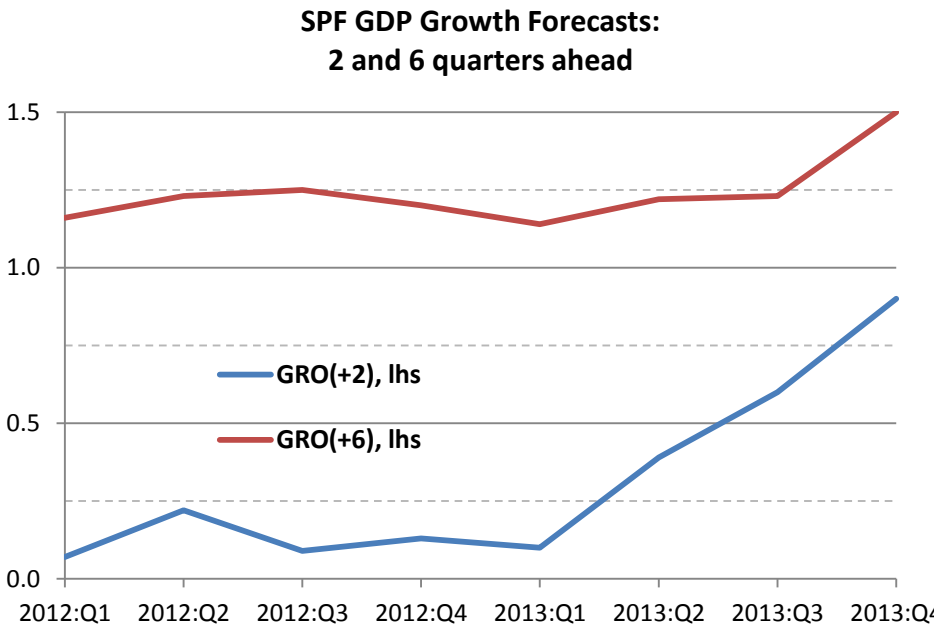


3.5. Projection based on November 7 cut and November SPF forecast



3.6. Change in SPF Forecasts





4. Exit from near zero rates: Traps and Risks

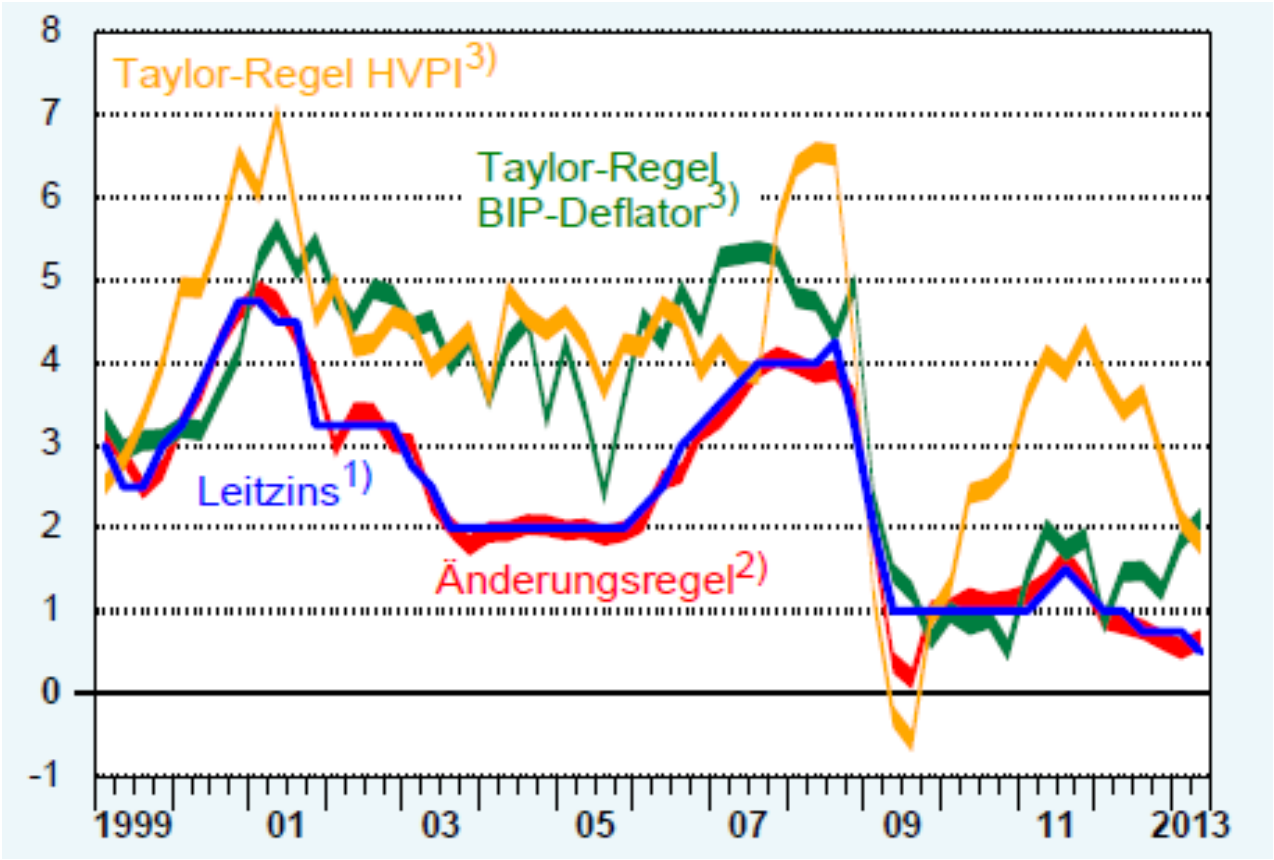
4.1. Interest rates too low for too long

- Monetary policy contributed to the excessive credit growth and mis-allocations prior to the financial crisis by keeping rates too low for too long.
- BIS warnings on excessive credit growth (Borio and White 2003).
- Taylor‘s rule signaled deviation of interest rate policy in the U.S. from about 2002 onwards (Taylor 2007).

4.2. Taylor's rule application to €-zone

- Taylor's prescribes level of policy rate based on nowcasts for inflation (yellow CPI, green GDP deflator) and output gap:

$$i_t = 2 + \pi_{t|t} + 0.5(\pi_{t|t} - \pi^*) + 0.5(Q_{t|t} - Q^*_{t|t})$$



Exit sooner rather than later!

4.3. Arguments for “lower for longer”

- Potential for liquidity trap / deflation trap.
  - But inflation rates are positive, and there is no strong and sustained deflation.
- Negative output gap and low growth.
  - But these are accounted for in Taylor‘s rule and the change rule (OW 2013) that fits historical ECB policy.

4.4. Dangers of “waiting too long”

- Lack of reform trap:
  - Low rate environment reduces governments‘ incentives for fiscal consolidation and structural reforms.
- Interest rate trap:
  - Low rates provide incentive for banks to postpone balance sheet improvement, and for governments to postpone costly banking sector restructuring.

4.5. How to improve €-zone exit conditions

- Move forward with banking union: Strict asset quality review by ECB – supported by national fiscal backstops - potential for recourse to ESM under national responsibility (Spanish program).
- OMT and low interest rate policy can only provide temporary relief in support of national governments consolidation and reform efforts.
- Continue with gradual fiscal consolidation as planned accompanied by growth-enhancing structural reforms.