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Introduction to the Monetary Policy Section

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One of the most remarkable features of the last seven years, since the beginning of the global financial crisis, has been the tremendous innovation and experimentation in the field of monetary policy. Pressed by circumstances, central bankers had to take bold and unprecedented actions. Some, of course, continue to do so.

With the passage of time, the question is how this experience has modified our view about the way monetary policy should be conducted in the future, once the crisis is behind us.

These introductory remarks focus on five areas where this question applies very starkly. First, should monetary policy be used to support financial stability? Second, how should monetary policy respond to the increasing risk of hitting the zero lower bound in an environment of persistently low interest rates? Third, how should monetary policy in emerging market economies (EMEs) and small open economies cope with the significant spillovers from monetary policy in their larger neighbors? Fourth, how should monetary policy communication evolve? And finally, what features of the unconventional monetary policy (UMP) toolkit should be maintained in more tranquil times? As these remarks are intended to introduce this chapter, they mostly aim to raise and motivate questions, instead of providing concrete answers.

Should Monetary Policy Be Used to Support Financial Stability?

This may be the quintessential question arising from the crisis, as it brings together the two big themes of the last seven years: monetary policy and financial stability.

We learned from the crisis that price and output stability do not ensure financial stability. During the Great Moderation, inflation expectations were well anchored in many advanced economies, inflation was stable, and output gaps were small, yet very significant risks to financial stability built up in the form of leverage, credit growth, fragile funding structures, common exposures, and loose lending standards. The natural question is thus whether the crisis might have been avoided had monetary policy followed a different course.

Tighter and more effective micro- and macroprudential policy and supervision would have been, no doubt, the preferred response. And indeed, looking ahead, these policies promise to be more effective at containing financial stability risks.

Initial evidence suggests that macroprudential policies can be relatively effective, at least in targeted areas. Korea was able to reduce banks' short-term external debt by half, to 27 percent, between 2008 and 2013. Australia limited the growth of uninsured "low-doc" mortgage loans by imposing higher risk weights (from 50 to 100 percent) on banks. In Brazil, higher capital requirements on new vehicle loans with high loan-to-value ratios decreased the growth of such loans. However, in some countries, such as Switzerland and the U.K., it is still too early to say whether macroprudential measures taken so far have been sufficiently strong to fully arrest housing-related risks. More evidence from around the world is needed to authoritatively gauge the effectiveness of macroprudential policies.

Thus the question is still worth asking: what if prudential policies are not sufficiently effective? Specifically, what if these policies are easily circumvented or arbitrated, slow to adapt to changing circumstances, overly targeted—in the sense of missing new sources of risks—or associated with negative side effects? Should monetary policy then come to the rescue of financial stability?

There are essentially three schools of thought. The first suggests that monetary policy can be used, but only as a second line of defense, after prudential policies have been fully exploited. The second argues that monetary policy should not be used to address financial imbalances, even as a second line of defense. Interest rates are too coarse a tool and thus impose too high a cost on the economy. The contribution of Lars Svensson to this volume espouses a similar view. The third school of thought

would disagree. It argues that monetary policy should always accompany prudential policies and thus continuously lean against financial imbalances. By virtue of being a coarse instrument, interest rates permeate all areas of the financial system.

But the discussion should now go beyond mere disagreement, often based on principle, relative to these schools of thought. In order to provide concrete policy advice to central banks, it is essential to undertake a detailed cost-benefit analysis of the general equilibrium effects of using monetary policy to support financial stability. The analysis has three legs: the benefits of monetary policy for financial stability, the costs from deviating from inflation and output objectives in the pursuit of financial stability, and the feedback to financial stability from inflation and output deviations. Only one of these legs, the second, is well known and accurately calibrated. But until more work is done to estimate the other two legs, policymakers will not be able to safely stand on this stool.

How Should Monetary Policy Respond to the Increasing Risk of Hitting the Zero Lower Bound?

Before the crisis, this risk was briskly set aside as improbable. The crisis was a stark reminder that the zero lower bound can occur and is costly. While UMPs in the form of asset purchases were successful at providing additional policy accommodation, their drawbacks do not make them close substitutes for conventional interest rate policy. In particular, asset purchases cannot be easily calibrated or adapted to changing economic conditions. They also entail substantial spillovers to other countries and may—if rates are kept low for an extended period—breed financial stability risks.

But even once economies recover and rates rise above the zero lower bound, the probability of returning to this constraint remains significant. This is because of the secular decline in real long-term interest rates, which hints at an equal pattern in the natural real rate of interest (real rates did not decrease because of higher inflation, or lower nominal yields, which eventually would have bred inflation had the natural rate not also declined). Low real rates and low inflation targets will translate into low nominal rates, and thus a persistent likelihood of hitting the zero lower bound when shocks materialize.

How should monetary policy avoid being constrained by the zero lower bound again in the future? One solution would be a higher inflation target. But this comes with costs. On the one hand, there are costs to central bank credibility, given the potential difficulties of anchoring expectations if the inflation objective is deemed movable, to hit a higher inflation target in an environment of low inflation and to convince markets that a higher target was not chosen to alleviate sovereign debt burdens. On the other hand, there are social welfare costs as higher inflation will complicate planning and price-setting decisions, and is usually accompanied by higher inflation volatility.

An alternative (or, for some, at least a complementary) solution exists: bolstering financial stability. In OECD countries outside the euro area, a third of zero lower bound episodes have followed the start of a systemic banking crisis by a year or less. The proportion rises if we allow for a longer lag. A more solid financial system would (1) decrease the size of financial shocks, (2) reduce the scope for amplifying shocks, and (3) allow monetary policy to respond more freely to shocks. As a result, the probability of hitting the zero lower bound would diminish, as would the expected duration of remaining at the zero lower bound following a particularly severe aggregate demand shock.

How Should Monetary Policy in Emerging Market Economies and Small Open Economies Cope with the Significant Spillovers from Monetary Policy in Their Larger Neighbors?

We live in an interconnected world. Small open economies—including many EMEs—may be significantly affected by capital flows unleashed by monetary policies in major economies. Rapid capital inflows can cause in recipient countries a surge in leverage, debt, asset prices, short-term funding, and balance sheet mismatches, exposing the financial system to large losses in the case of sudden stops and related market volatility.

The crisis highlighted the extent to which capital flows can affect asset prices in emerging markets. Between 2009 and the end of 2012, emerging markets received about US \$4.5 trillion of gross capital inflows, representing roughly one-half of global capital flows. More specifically, the example of South Africa, discussed later by Gill Marcus, is telling. Ten-year

government bond yields decreased by nearly 250 basis points in the four years of especially accommodative monetary policies in advanced economies following the Lehman bankruptcy (from 8.8 percent in September 2009 to 6.4 percent in May 2013), only to bounce back by almost the same amount in the three months between May and August 2013, during the so-called taper tantrum.

How should monetary policy respond in the countries receiving large capital inflows, and exposed to the risk of sudden outflows? As discussed earlier, prudential policies and supervision will be paramount to support the resilience of the financial sector. But these steps may not be sufficient, and monetary policy will face difficult trade-offs. For instance, capital inflows can lead to overheating. But to what extent will higher rates attract more foreign capital and encourage liabilities to shift into foreign currency? Capital flows can equally lead to a decrease in domestic inflation as the domestic currency appreciates. If the pattern persists, a cut in interest rates could be appropriate; but to what extent would this measure further stoke credit growth and leverage? Central banks may thus be tempted to resort to other means to slow capital inflows more directly, such as foreign exchange interventions or capital flow management measures. But to what extent would these measures be effective, and how should they be designed?

These questions go beyond the goal of containing short-term market volatility. A more fundamental question is, can EMEs and small open economies maintain monetary policy independence? There are two ways to pursue this question. First, can these economies set interest rates independently of foreign interest rate dynamics, even under floating exchange rates? While it is natural for countries to take foreign economic conditions into account, not all countries will take the additional step of shadowing foreign interest rates in order to manage pressures on the exchange rate and capital flows. Second, and perhaps a deeper issue, has the transmission mechanism of monetary policy lost its effectiveness in EMEs and small open economies? In other words, to what extent do output and inflation, but also credit growth and financial stability, depend on foreign, as opposed to domestic, monetary policy? And if the transmission mechanism has lost its effectiveness, what would it take to regain monetary policy independence?

How Should Monetary Policy Communication Evolve?

The crisis has shined a spotlight on signaling, and especially on the role of communication for signaling. Deprived of short-term interest rates, central bankers had to resort to words—in addition to concrete UMP measures—to signal their future policy intentions to the public. At least two areas are worth exploring in an attempt to draw lessons from experience. The first is communication about policy expectations (the modal policy response), and the second is communication about uncertainty (higher moments of the policy response).

Communication should be geared toward supporting the predictability of policy responses. This entails clarifying policy intentions and their justification. But these change in ways that depend on the economic environment. For instance, the relationship between unemployment and wage inflation has been erratic in the United States, undermining the intentions of the Fed to provide guidance on the timing of rate normalization by communicating thresholds related to unemployment. This sort of situation leads to the debate captured in the contributions by Ben Bernanke and John Taylor, about targets-based, versus rules-based, frameworks. In the first, the role of central bank communication is to elucidate the strategy to bring the forecasts of key variables back to their objectives. In the second, it is to explain deviations from immutable and simple instrument rules.

The balancing act that communication must play is even more complex. Communication should not just inform the public's expectations of future policy action; it should convey a sense of existing uncertainty about economic prospects, and possibly about policy responses themselves. The danger is that communication focused on clarifying a modal policy path conveys a false sense of economic and policy predictability, which in turn could prompt an undervaluation of risks. More information—even if about uncertainty—is always better, at least on paper.

But in practice, can communication be used to convey an accurate sense of uncertainty, without creating undue uncertainty itself? Clearly, central banks should not artificially inject uncertainty by clouding their intentions in vague language or, worse, by randomizing their policy actions. But could central banks educate the market as to existing uncertainty, perhaps by publishing stress tests or contingency plans for monetary

policy, instead of focusing mostly on modal outcomes? A lot depends on how well the public understands the nature of conditional statements. On this basis, the experience of the crisis has not been especially encouraging, as illustrated by the summer 2013 “taper tantrum” episode.

What Features of the Unconventional Monetary Policy Toolkit Should Be Maintained in More Tranquil Times?

During the crisis, central banks introduced a variety of new instruments. These included longer-term liquidity provision to a wide range of financial entities and markets, price backstops in certain highly volatile markets (such as done by the Term Asset-Backed Securities Loan Facility, or TALF, in the United States), private and public asset purchases, conditional funding operations to encourage bank lending, and policy rate cuts into negative territory.

While some of these measures are clearly aimed at restoring market functioning and banking intermediation under extreme economic conditions, others could still be used in more tranquil times. Asset purchases in particular could become a more standard tool. One purpose might be to enhance signaling, and more finely manage the yield curve by targeting long-term bond yields. But this would come at the cost of volatility in shorter-term bond yields and some loss in the efficiency of monetary policy transmission, given the difficulty of calibrating asset purchases to target specific longer-term interest rates.

More generally, though, central banks might wish to keep larger balance sheets than before the crisis. If excess reserves remained substantial, market interest rates could be managed by setting interest rates on excess reserves or short-term reverse repo operations. A larger balance sheet would also provide a liquidity buffer to the banking sector, and could provide the wider private sector with an elastic supply of safe and liquid assets. Ultimately, the question is how much central banks should make use of their balance sheets in the future, and what their optimal balance sheet size is.

Many of these questions are investigated in the remainder of this part of the volume, but it will take more time—and solid analysis—before final verdicts can be advanced. For now, monetary policy will continue being more art than science.

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Progress and Confusion

The State of Macroeconomic Policy

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