Monetary Policy in the New Normal

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Motivation

- Financial crisis has had important consequences for monetary policy:
  1. Central banks across the world have been forced to conduct monetary policy in new and innovative ways.
  2. Economic environment has changed in a lasting way.

- What will the long-term impact on monetary policy be?
  - Will differ between central banks depending on economy-specific factors.
  - Give my personal views; not focussing on any specific central bank.

Monetary policy before the crisis

- While there were differences between central banks, there were important similarities:
  - Price stability the overriding objective.
    - Explicit or implicit inflation targeting.
  - Stabilising the business cycle secondary objective.
  - Financial stability of little, if any, importance.
    - Pursued through regulation of individual institutions.
  - Short-term interest rate sole policy instrument.
  - Size of central bank’s balance sheet unimportant.
  - Monetary policy set “one meeting at a time.”

Central banks face a more hostile economic environment

- Very large public debts in some countries.
  - Fiscal policy tight for a long time to come.

- Financial system impaired in some countries and banks face a greater regulatory burden.
  - Banks more aware of risks and are more prudent.
  - Monetary policy transmission has weakened.

- Private sector debt overhangs.
  - Deleveraging, low growth and low inflation.
  - Real (indexed) long bond yields exceptionally low.

Central bank policy responses during crisis

- Monetary policy makers faced an unprecedented combination of problems:
  1. Large, unexpected shocks in the financial system that slowed the economy.
  2. Reduced at the same time the effectiveness of traditional monetary policy tools.
     - Reached the zero lower limit on interest rates.

- Responded with unprecedented measures.
  - Differences between countries arising from dissimilarities in economic conditions and structures.

Five questions

1. Should central banks' objectives for price stability be changed?
2. Should monetary policy also have a financial stability objective?
3. How should financial stability be pursued?
4. How will central banks' implementation of policy change?
5. What will happen to unconventional monetary policy?

Question 1: Price stability?

- Does price stability remain the right objective?
  - Did central banks focus too much on inflation and too little on financial stability before the crisis?
  - Did that lead them to set too low interest rates, triggering financial risk taking?
  - Would higher inflation targets provide more room to cut interest rates in a future crisis?

- Not desirable to change objectives for inflation (but criticism has been taken to heart).

Question 1: Price stability? (2)

- Price stability remains the appropriate objective for monetary policy.
  - Not desirable to raise higher inflation objectives.
  - Credibility losses.
- Central banks overestimated banks' ability to manage risk, and ability of regulators to prevent excessive risk taking.
  - Unlikely to repeat this mistake.
- Low interest rates such as those before the crisis are sometimes needed to prevent too low inflation.
  - A second policy instrument is needed to mitigate financial stability risks.

Question 2: Should monetary policy also have a financial stability objective?

- Before crisis there were two views:
  - "Lean" against housing bubbles with interest rates.
  - "Clean" up after a bust with low interest rates.

- Most central banks preferred not to "lean."
  - Sentiment has shifted; some agree that interest rates can be used under some circumstances.
  - However, monetary policy cannot always be used:
    - Cannot be used under a fixed exchange rate.
    - Bubbles tend to be limited to one or a few countries in a monetary union.
    - Using interest rates has macroeconomic costs.

Question 3: How should financial stability be pursued?

- To mitigate financial stability risks, a second policy tool is required.
  - Macro prudential policy.
  - Reduces the financial system’s ability to extend credit, given the central bank’s policy rate.
    - Capital buffers, liquidity rules, loan-to-value and loan-to-income ratios …
  - Makes it more difficult and costlier to obtain credit.
    - More targeted than monetary policy.
  - Should it be coordinated with monetary policy?

Question 4: How will central banks' implementation of policy change?

- Policy focussed on one short-term rate.
  - Limited importance of its own but influenced longer, more economic relevant rates.
- Liquidity provision became more important.
  - Quantities versus prices.
  - Market operations more frequent; longer maturities; more counterparties; greater variety of collateral.
  - Interventions to support market segments.
- Greater variety of operations will be maintained.

Question 5: What will happen to unconventional monetary policy?

- When policy rates reached zero, central banks introduced unconventional policy:
  - Aimed to reduce long interest rates.
- Two forms:
  - Large-scale asset purchases.
  - Forward guidance.
- Effective, but less so than traditional interest rate policy and difficult to calibrate.
  - Will probably become less important.

Summary: How might monetary policy be changed once recovery is complete?

- Difficult to guess (and important differences between central banks will remain).
  1. Inflation objectives unchanged.
  2. More focus on financial stability in setting interest rates, and therefore some loss of inflation control.
  3. Macro prudential policy playing growing role.
  4. Greater variety of market operations.
  5. Unconventional monetary policy less important.