The “new normal” of monetary policy

Monetary Policy, Economic integration and the “New Normal”

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01.11.2018
I. THE CONTEXT

New “normal” of monetary policy

- Binding lower bound
- Intertwined relationship between monetary policy and financial stability
- More complex operational framework
- Specific challenges for developing markets
CONTENT

I. THE CONTEXT

II. THE LOW INTEREST RATE ENVIRONMENT

III. THE RELATIONSHIP BETWEEN FINANCIAL STABILITY AND MONETARY POLICY

IV. CONCLUSIONS
II. The low interest rate environment

Global real interest rates since 1980
II. The low interest rate environment

Contributing Factors

- Demographics and income inequality
- Decline in investment rates
- Increased demand of “safe assets”
- Increased level of indebtedness
- Global pattern of saving and investment
II. The low interest rate environment

Policy Options

Pursuit of price stability

Non-standard policy tools

Modify the policy framework
II. The low interest rate environment

Monetary policy toolkit

- Forward guidance
- Yield curve control
- Large Scale Asset Purchases
- Negative interest rates
- Short-term interest rates
II. The low interest rate environment
Developing markets features

Larger, difficult-to-forecast shocks and less sophisticated forecasting capabilities

• They make “Odyssean” forward guidance undesirable and “Delphic” forward guidance unlikely to be abided by.

Under-developed capital markets

• It is more difficult to anchor medium- and long-term yields of a wide range of financial instruments within a bank-centric financial system funded via short-term deposits.

Greater risk of fiscal dominance

• It may impair the effectiveness of monetary policy and contribute to an unsustainable policy mix

Greater vulnerability to destabilizing financial stability developments

• Interest Rates need to remain positive at a spread over the “anchor” currency to prevent asset redenomination, destabilizing capital flows and bank disintermediation while encouraging saving and capital formation.
II. The low interest rate environment
Modify the policy framework

Entail greater flexibility; more difficult to communicate; dependent on credibility

Raise the inflation target
• Create greater cushion over the lower bound but transition difficult and expectations may be fundamentally undermined if central bank is perceived to be tinkering with target on tactical grounds. Inflation may become more volatile

Switch to price-targeting (Svensson, 1999; Gaspar, 2007)
• Offset periods of undershooting with periods of overshooting but it makes it difficult to “look-through” negative supply shocks.

Flexible price-targeting (Bernanke, 2017)
• Adopt price-targeting only after periods in which policy rates are constrained by the ELB but significant operationalization challenges persists.
II. The low interest rate environment

Developing markets concluding considerations

Advanced economies solutions to low interest rates hardly applicable and higher ELB

Tweaks to the monetary policy frameworks not equally applicable/desirable

New monetary policy instruments at the ELB may not be desirable/applicable

Low interest rate environment not a pressing priority

Developing markets do not experience same saving glut

Higher inflation targets to facilitate convergence process and real price adjustment

Higher natural real interest rate due to higher returns on capital
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III. Monetary Policy and Financial stability

Close-to-target inflation and output gaps not sufficient for macro stability

Source: World Economic Outlook (September 2007 vintage for the output gap) and Haver Analytics.
III. Monetary Policy and Financial stability

Relationship between monetary policy and financial stability

Structural

Cyclical
III. Monetary Policy and Financial stability

Cyclical

Lean Against the wind?

- Are financial risks excessive?
  - no: Continue monitoring
  - yes: Is macroprudential effective?
    - yes: Consider leaning against the wind
    - no: Are there tradeoffs with traditional monetary policy?
      - yes: Carry out traditional policy
      - no: Carry out traditional policy

Source: IMF staff.
III. Monetary Policy and Financial stability

“Lean Against the wind” is even less compelling in partially dollarized developing markets with floating exchange rate

Capital flows very elastic to interest rate differentials

- Tighter monetary policy may fuel more short-term, speculative capital flows exerting upward pressure on the exchange rate

Exchange rate appreciation may lower the weight of foreign currency liabilities

- This may fuel more loans’ euroization in absence of an effective prudential framework and may encourage more leverage

Stronger business case for deploying macroprudential tools
III. Monetary policy and financial stability

**Structural**

Major impact of capital and liquidity regulations on market functioning and market behavior

- They penalize the interbank market and the circulation of liquidity
  - Pre-crisis operational frameworks relied on the interbank market for the redistribution of liquidity
  - In the post crisis operational framework banks will rely more on central bank’s intermediation role

- They make financial arbitrage more difficult
  - More difficult to steer interest rates unless central banks interact with a plurality of counterparties in a plurality of markets and segments

- Banks interaction with central bank increase as consequence of regulation and Basel III ratio compliance
  - It is doubtful the extent in which central banks should and could hinder the use of their facilities for regulatory purposes.
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IV. Conclusions

Pursuit of price stability
Stronger business case for deploying macroprudential tools
THANK YOU!
BACKGROUND SLIDES
The low interest rate environment

3-month ex-post real rates since 1875

Monetary policy and financial stability

Major impact of capital and liquidity regulations on market functioning and market behavior.

Shift from mid-corridor to floor systems with a risk of losing control over reserve money.