The “new normal” of monetary policy

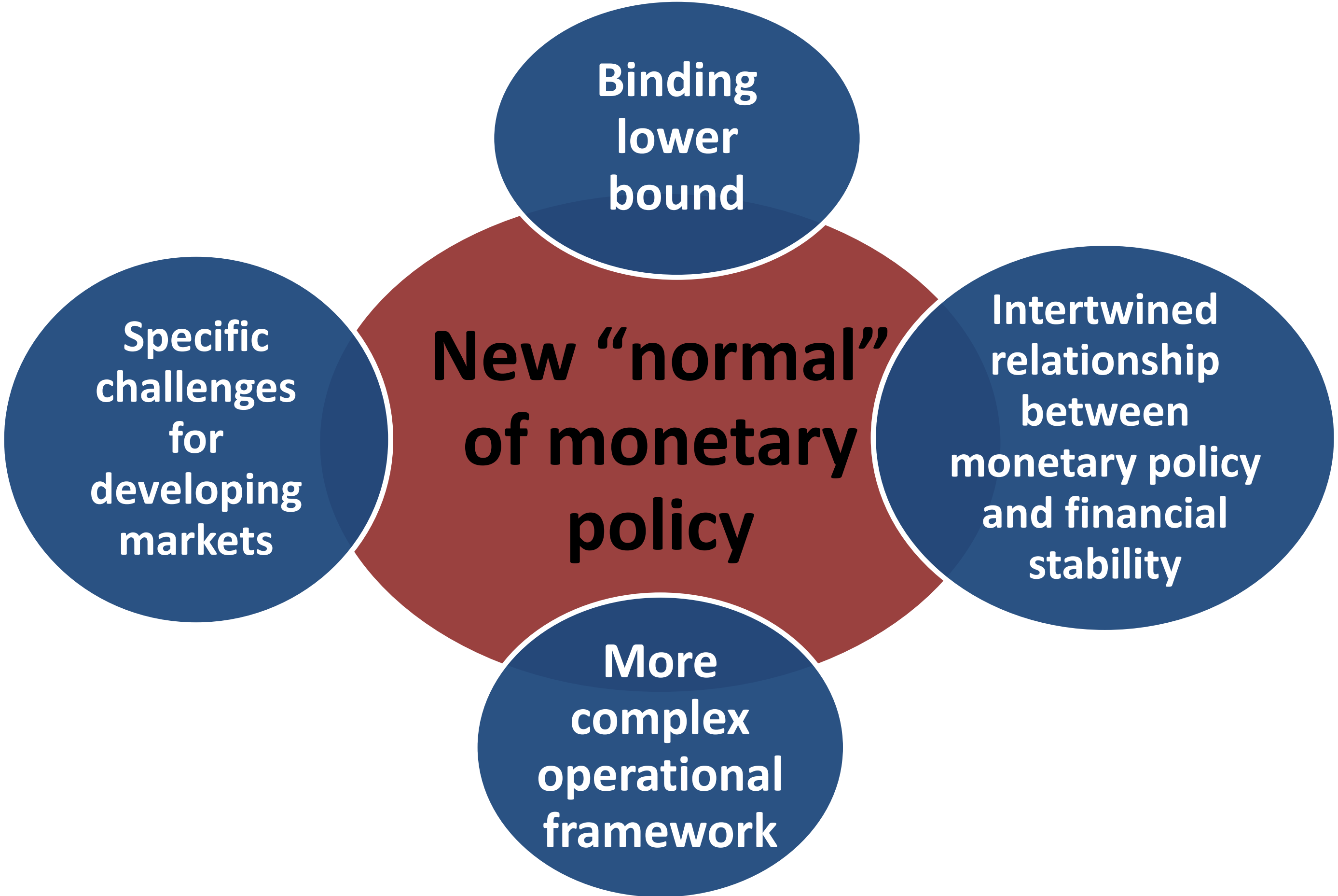
Monetary Policy, Economic integration and the “New Normal”

Guido Della Valle

Tirana

01.11.2018

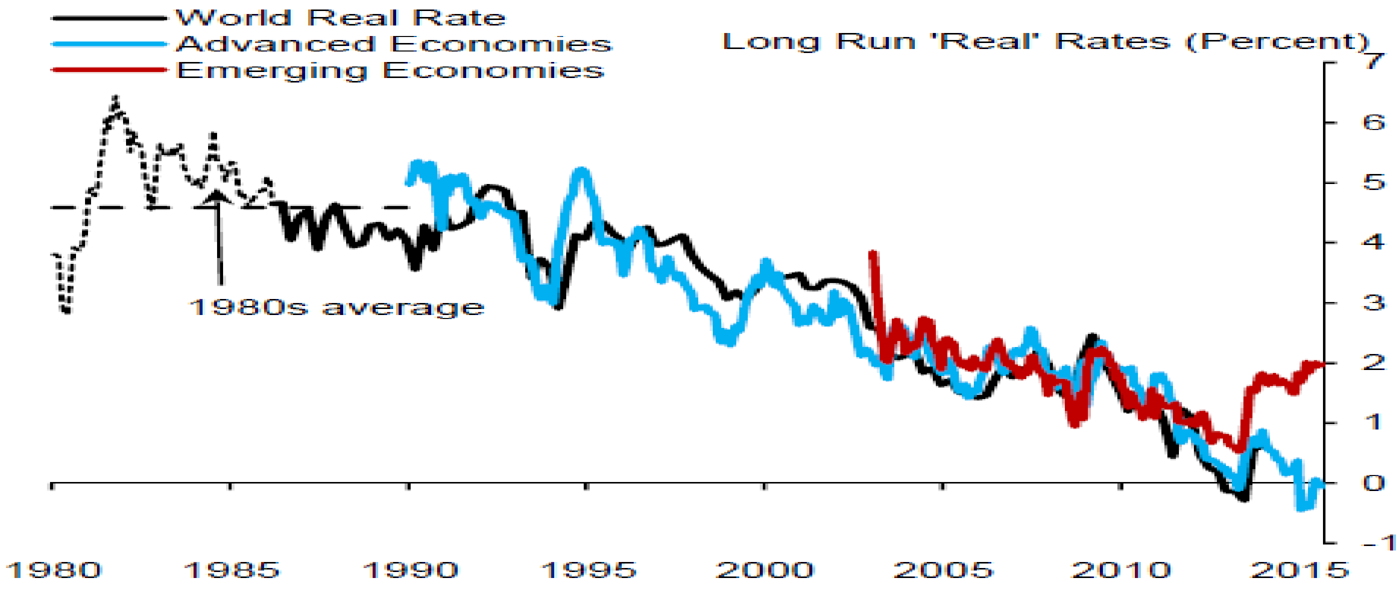
I. THE CONTEXT



CONTENT

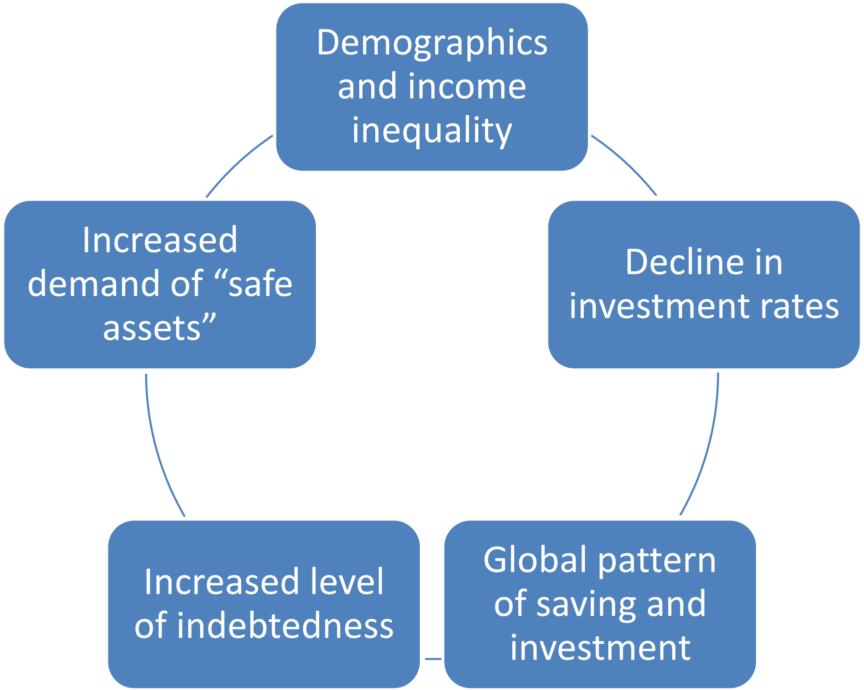
II. The low interest rate environment

Global real interest rates since 1980

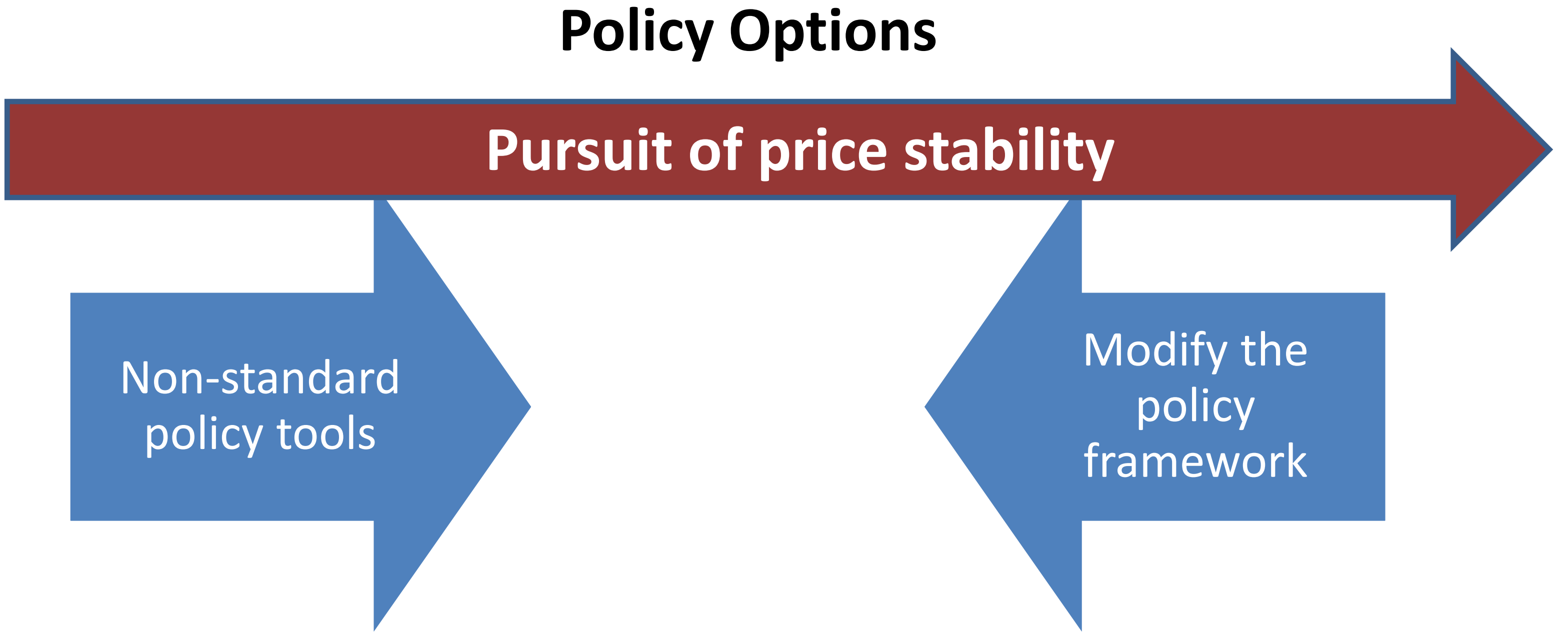


II. The low interest rate environment

Contributing Factors

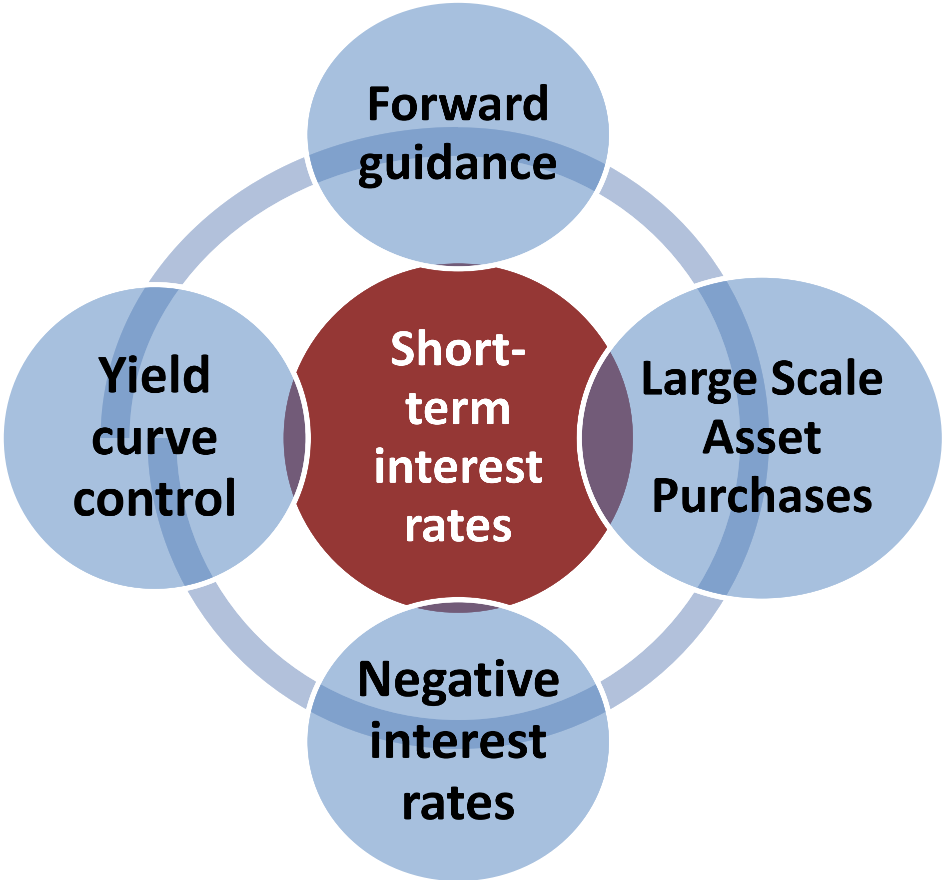


II. The low interest rate environment



II. The low interest rate environment

Monetary policy toolkit



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 a 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

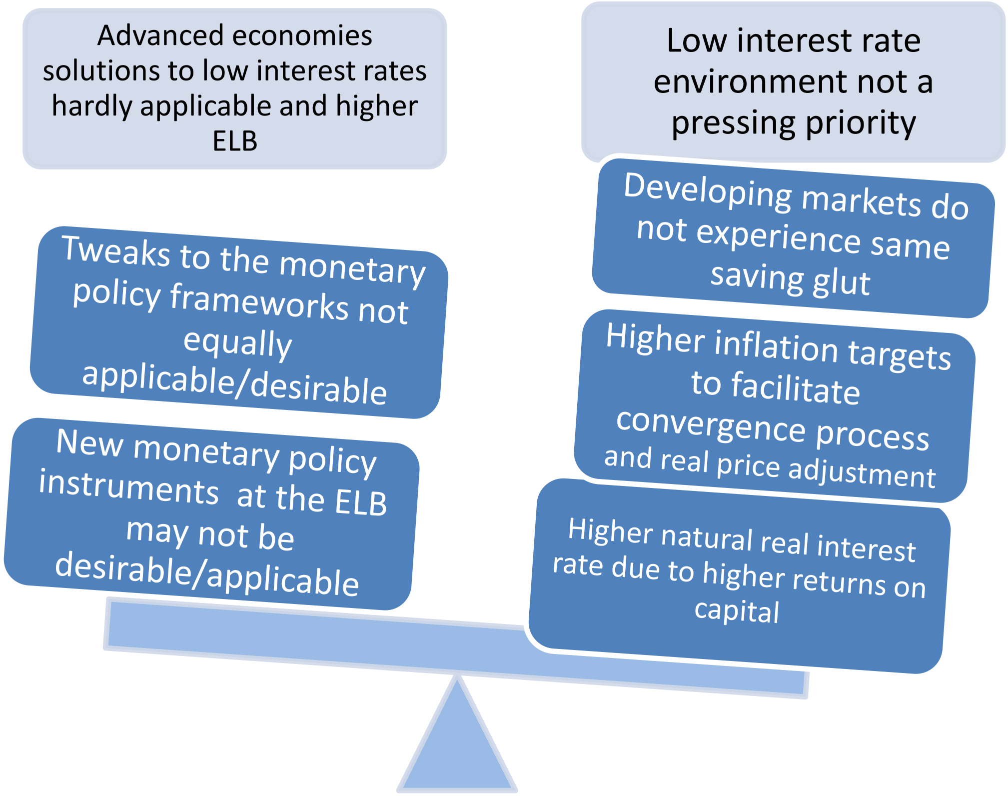
Switch to price-targeting (Svensson, 1999; Gaspar, 2007)

- 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.

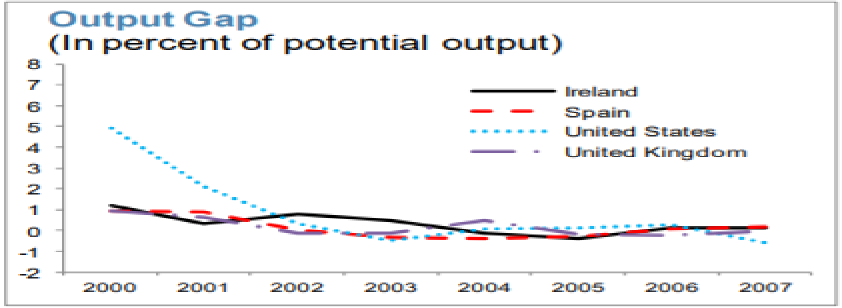
II. The low interest rate environment
Developing markets concluding considerations

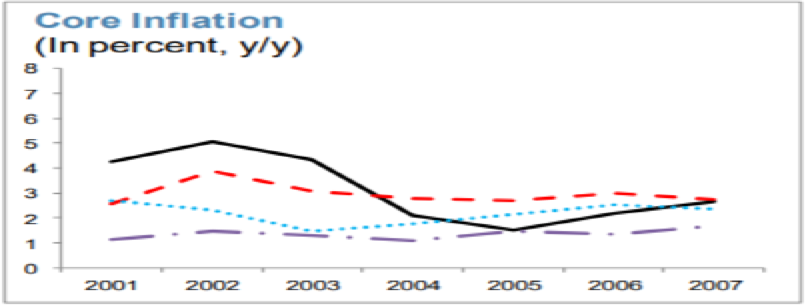


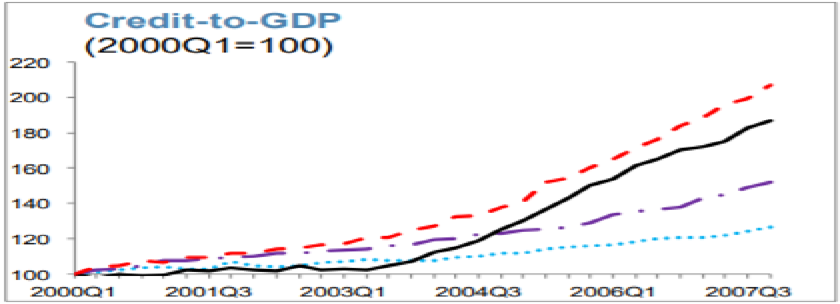
CONTENT

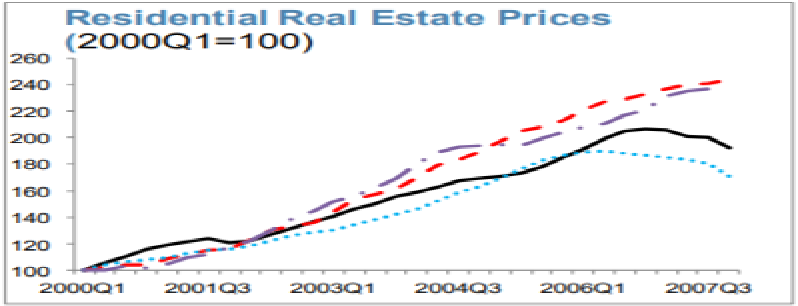
III. Monetary Policy and Financial stability

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



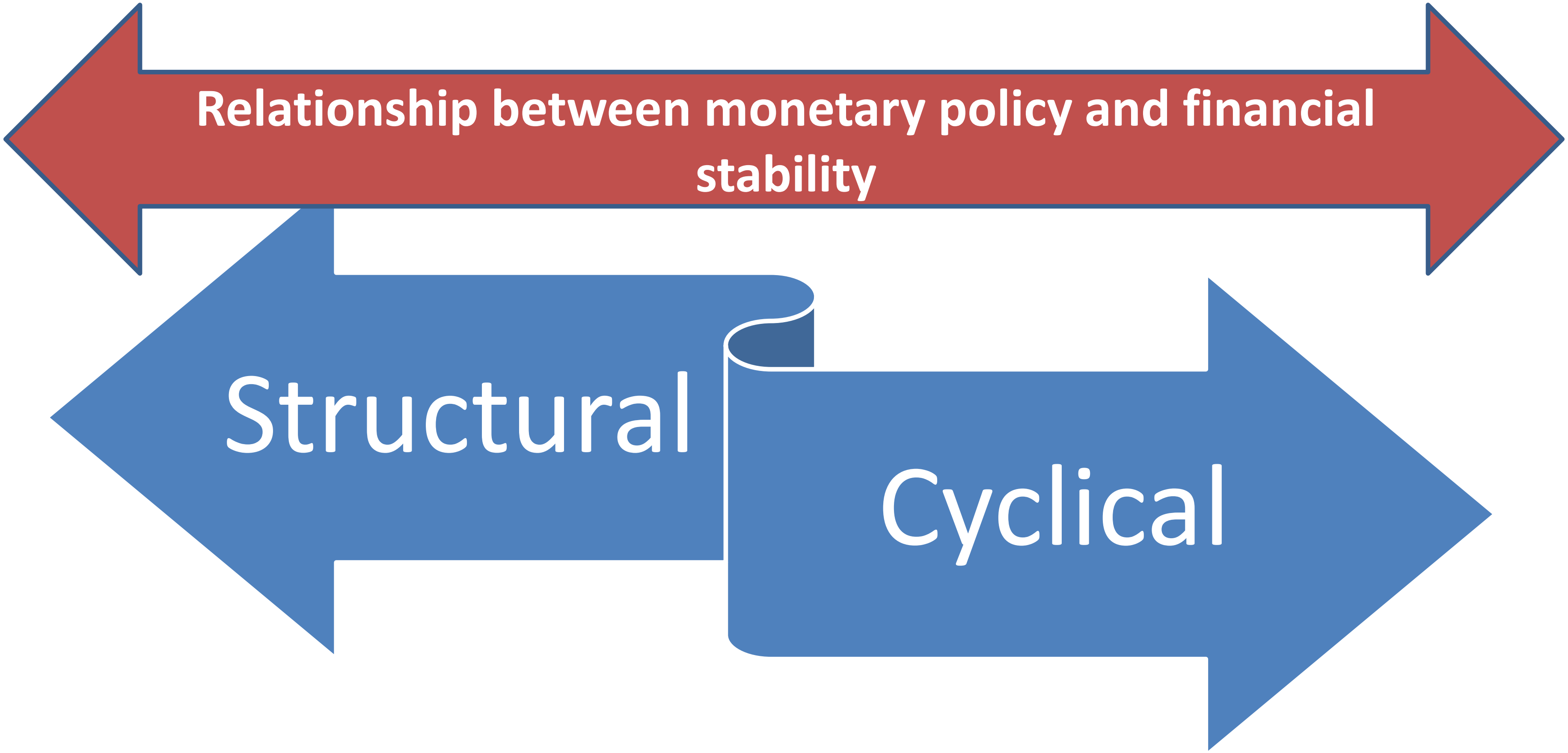






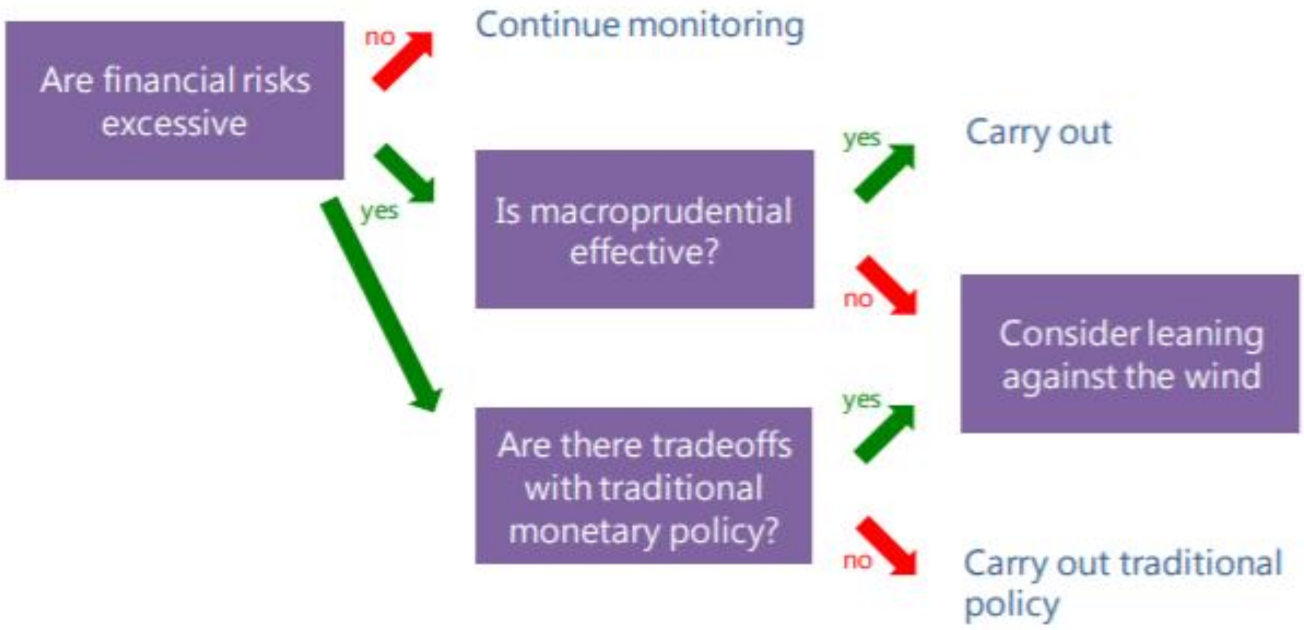
Source: World Economic Outlook (September 2007 vintage for the output gap) and Haver Analytics.

III. Monetary Policy and Financial stability



III. Monetary Policy and Financial stability

Cyclical
Lean Against the wind?



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.

CONTENT

I. THE CONTEXT

II. THE LOW INTEREST RATE ENVIRONMENT

III. THE RELATIONSHIP BETWEEN FINANCIAL STABILITY AND MONETARY POLICY

IV. CONCLUSIONS

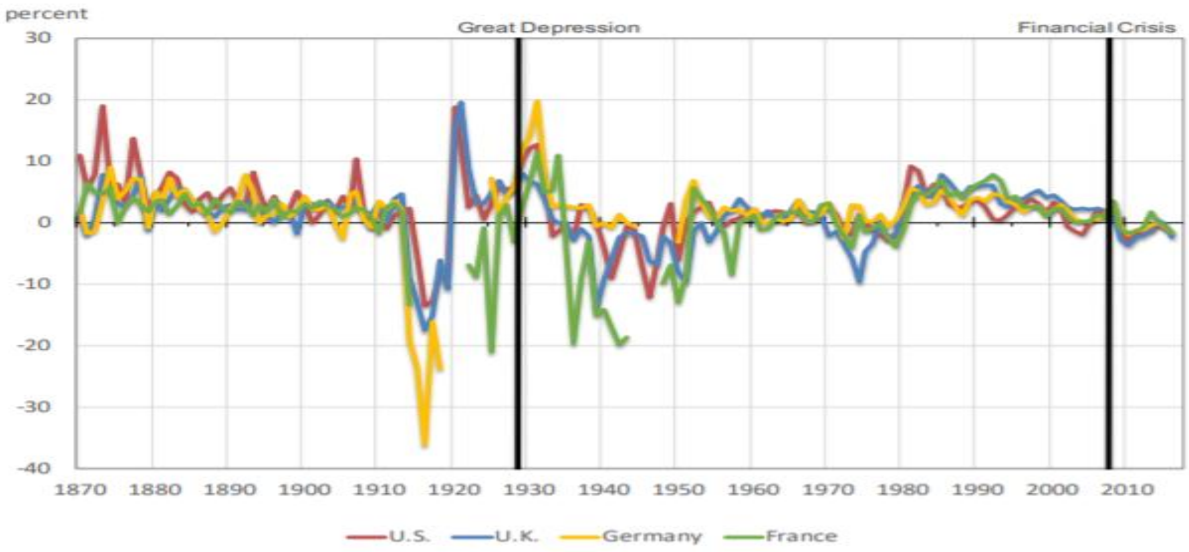
IV. Conclusions

THANK YOU!

BACKGROUND SLIDES

The low interest rate environment

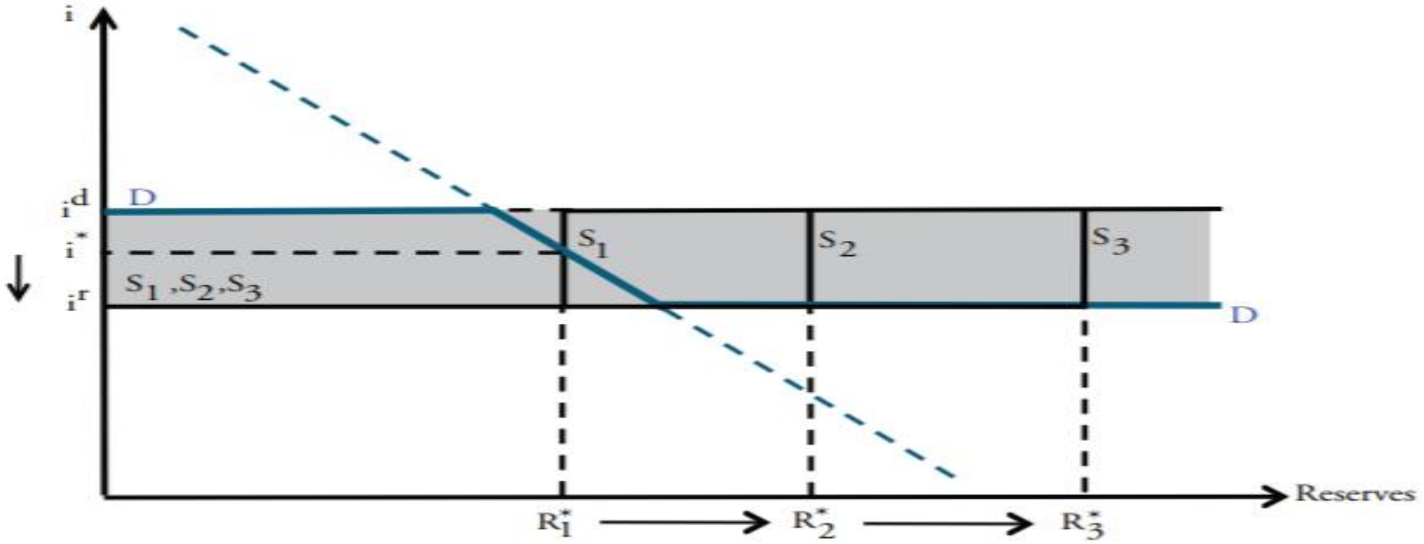
3-month ex-post real rates since 1875



Source: Gourinchas, P-O., H. Rey, 2018, Global Real Rates: A Secular Approach.

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