What Lies Beyond Price Stability?

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Monetary Policy 2.0?
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What is the role of central banks?

- Price stability.
- Economic stability/full employment. (?)
- Financial stability. (??)
- Fiscal stability/sustainability. (???)



What is the role of economic policy?

- Ultimate objective is welfare of the public.
- Policy institutions:
  - Monetary authority.
  - Financial supervision/regulation authority.
  - Fiscal authority.
- Practical institutional design problem is to assign operational objectives, powers, responsibilities among policy institutions to best attain ultimate objective.
- Practical difficulty is to properly account for policy interactions.



Monetary Policy 1.0?

- Monetary policy (stylized view of the "Great Moderation" era):
  - Stability-oriented with focus on price stability.
  - Contribute to economic stability/full employment as secondary goal.
  - Downplay interactions with financial stability. Contribute to financial stability mainly by maintaining price stability and economic stability.
  - Downplay fiscal implications as much as possible.
- Financial stability mainly the responsibility of micro supervision/regulation authority.
- Fiscal stability/sustainability of government finances over time the responsibility of the fiscal authority.
- Focus on price stability and separation of tasks a crucial argument for institutional independence of central banks.



Back to the Future? What Lies Beyond Price Stability?

- Price stability was **not** the original function of central banks. Examples:
  - Banque de France founded in 1800 by Napoleon Bonaparte to facilitate government finance at favorable terms.
  - Federal Reserve was founded in 1913 to provide an elastic currency towards maintaing financial stability.
- In the early days of central banking, the primary goal of the central bank could be understood as either financial stability or fiscal stability.
- Framework proved unsatisfactory leading to the evolution towards central bank independence with a price stability mandate.

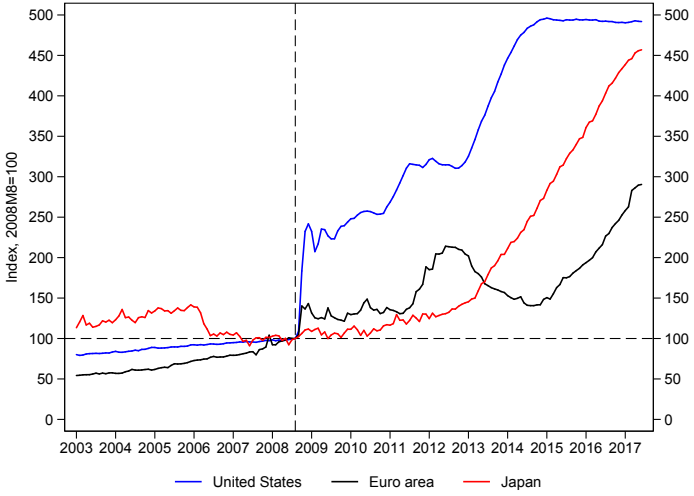


Beyond Monetary Policy 1.0?

- Crisis shattered comfortable separation of tasks.
- Financial stability intimately related to central bank policy framework, including the use of the central bank balance sheet for lender of last resort and market-maker of last resort functions.
- In periods of stress, central bank balance sheet policies crucial determinants of fiscal stability/sustainability.
- How best to redesign the overall policy framework?
  - Step 1: Acknowledge power of central bank balance sheet.
  - Step 2: . . .
  - Step 3: . . .



The power of central bank balance sheets



Index, August 2008 = 100.

How best to redesign the overall policy framework?

- Step 1: Acknowledge power of central bank balance sheet.
- Step 2: Acknowledge tensions in Monetary Policy 1.0.
  - Interactions with financial stability.
  - Interactions with fiscal stability/sustainability.
- Step 3: Embrace interactions and rethink policy.
  - Considerable progress with respect to financial stability.
  - Uneven progress with respect to fiscal stability/sustainability.



Fiscal stability/sustainability

- An uncomfortable truth:

  > *"Almost every action the central bank undertakes has fiscal consequences." Stanley Fischer (2010).*

- Central banks have considerable leeway to use their discretionary authority to allay fiscal concerns without compromising price stability.

- Especially important since the crisis:
  - Limited fiscal space in many economies.
  - QE policies have profound fiscal effects.
  - At ZLB, fiscal expansion is efective stabilization tool.



Debt dynamics and multiple expectational equilibria

$$\Delta b_t = (r - g) b_{t-1} + d_t$$

b_t, debt (ratio to GDP).
d_t, primary deficit (ratio to GDP).
r, real interest rate.
g, real GDP growth.

- Within a range of fundamentals for growth and projected primary deficits, multiple expectational equilibria are possible in debt markets.
- If fears of default are allowed to raise r, debt may become unsustainable even with sound fiscal fundamentals.
- Role of central bank in defending against unjustified risk premia?
- The snowball effect: $r > g$ vs $r < g$.



BoJ: QQE with YCC

"The Bank will apply a negative interest rate of minus 0.1 percent to the Policy-Rate Balances in current accounts held by financial institutions at the Bank."

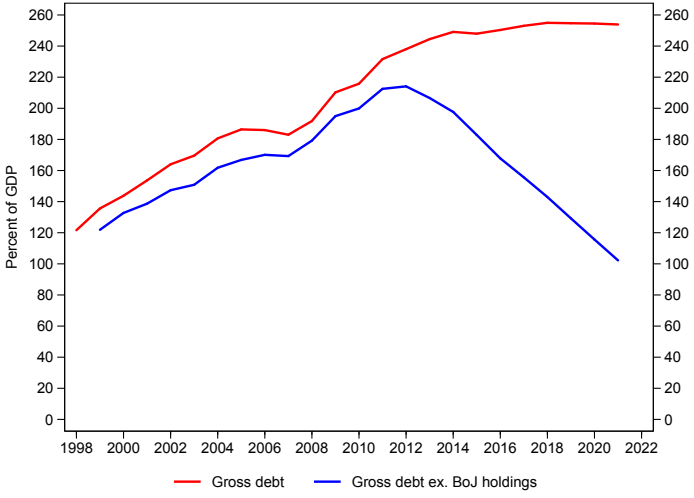
"The Bank will purchase Japanese government bonds (JGBs) so that 10-year JGB yields will remain more or less at the current level (around zero percent). ... an annual pace of increase in the amount outstanding of its JGB holdings at about 80 trillion yen ..."

"The Bank will continue expanding the monetary base until the year-on-year rate of increase in the observed CPI (all items less fresh food) exceeds the price stability target of 2 percent and stays above the target in a stable manner."

(Bank of Japan, 21 September 2016)

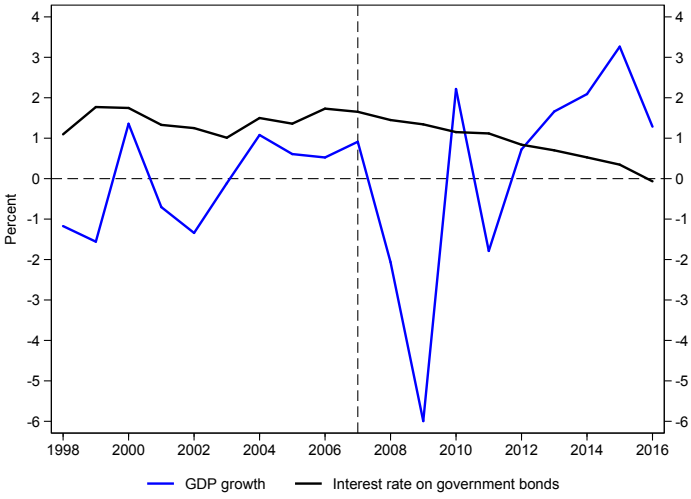


Japan's debt: The power of the BoJ balance sheet

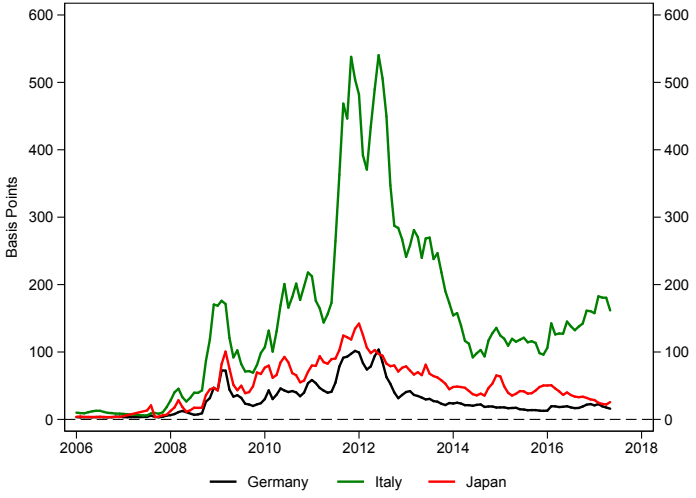


Gross debt ratio. Based on IMF projection, IMF WEO, April 2017. Actual BoJ holdings until June 2017, subsequently projected assuming annual purchases of 80 trillion yen.

The BoJ and the snowball effect

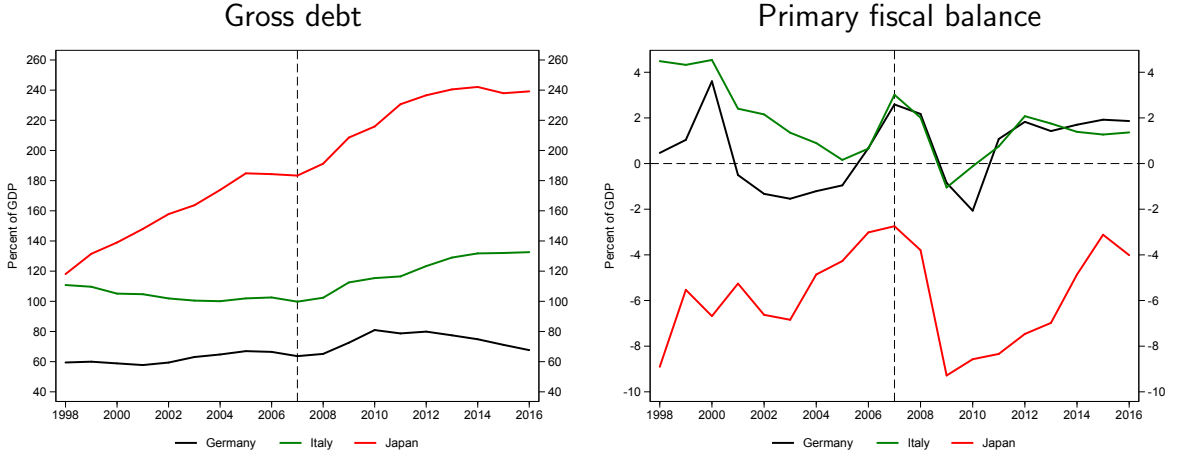


Fiscal interactions: BoJ vs ECB



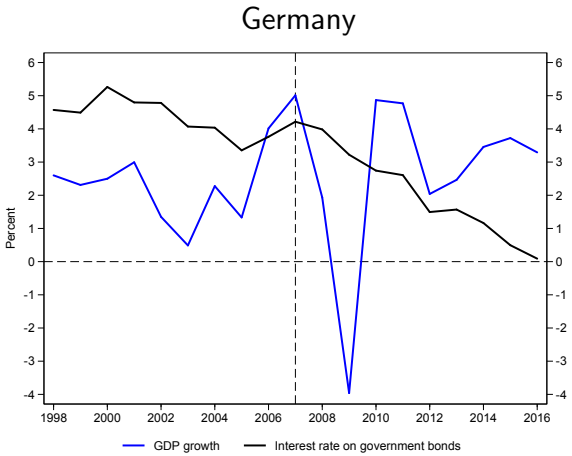
Five-year CDS spread on sovereign debt.

Japanese frugality vs Italian profligacy?



Debt and primary fiscal balance as a percent of GDP. IMF WEO, April 2017.
Negative fiscal balance corresponds to fiscal deficit.

The ECB and the snowball effect: Germany vs Italy



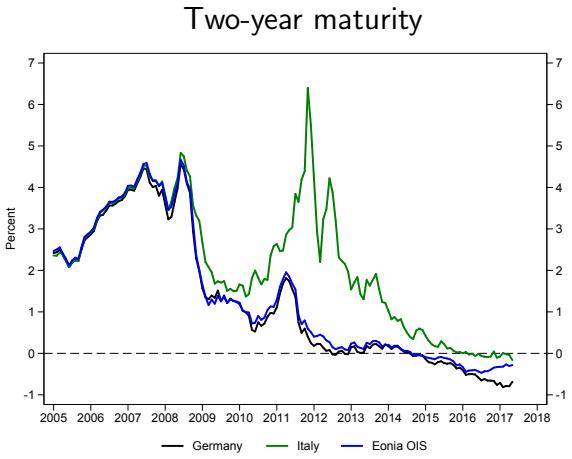


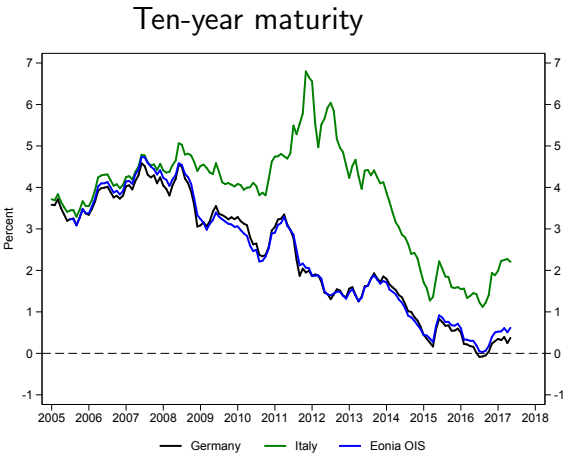
ECB

- Has the ECB embraced the interactions of its monetary policy with fiscal stress?
- Has the ECB properly defended against unjustified risk premia in euro area government bond markets?
- Distributional side-effects?



ECB monetary policy: Government bond yields vs OIS





Financial stability

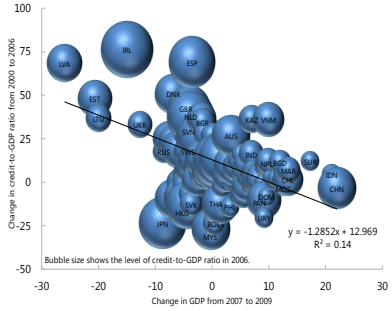
- Interconnection of monetary policy and financial stability widely acknowledged. (Contrast with uneven acceptance regarding fiscal stability.)
- Macroprudential policy recognized as a complement to monetary policy.
- However, numerous open questions:
  - Confident about the effectiveness of macroprudential policy tools?
  - Systematic application of macroprudential policy tools?
  - Effective decision making structure for coordination with monetary policy?
  - Relative costs and benefits of leaning-against-the-wind monetary policy?



Lean vs Clean?

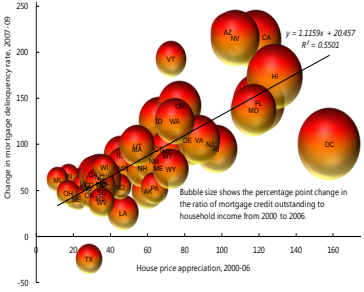
Figure 2. Growing Financial Vulnerabilities and Costs of the Crisis

Credit Growth and Depth of Recession



Sources: IMF International Financial Statistics; IMF staff calculations.
Note: Each data point corresponds to a country, indicated by the three-letter abbreviations.

Linking Booms to Defaults



Sources: Federal Housing Finance Agency, Mortgage Bankers Association, Bureau of Economic Analysis, U.S. Census Bureau.
Note: Each data point corresponds to a U.S. state, indicated by the two-letter abbreviations.

IMF Staff report on "Monetary Policy and Financial Stability" (2015).

Monetary Policy 2.0

- Price stability is the appropriate primary goal of monetary policy.
- However, success in defending price stability insufficient to maintain financial stability or fiscal stability.
- Central banks should embrace discussion on how to improve the overall policy framework.
- Crises are learning opportunities. Penitence can help central banks avoid repeating mistakes.



Penitence as a form of learning (Rotemberg, 2013)

"[S]ome of the changes in the Fed's approach to monetary policy are consistent with a form of penitence, where this penitence is the end result of a three-step process. First, there are some deplorable economic results such as those in the initial 1930 downturn, the full Great Depression, the recessions of 1957 and 1960, or the Great Inflation. Second, critics attribute these results to patterns of Fed behavior that are interpreted as having been mistaken. Third, the Fed acts as if it implicitly accepted one of these criticisms and becomes averse to the criticized pattern of behavior. It is possible to view this form of penitence as helping the Fed perfect its approach to monetary policy. Particularly if one agrees with the critics, this penitence would represent a form of learning: it leads the Fed not to repeat mistakes."
Julio Rotemberg (2013)

