

Uncertain inflation outlook and monetary policy normalization in the heterogeneous euro area

Zsolt Darvas

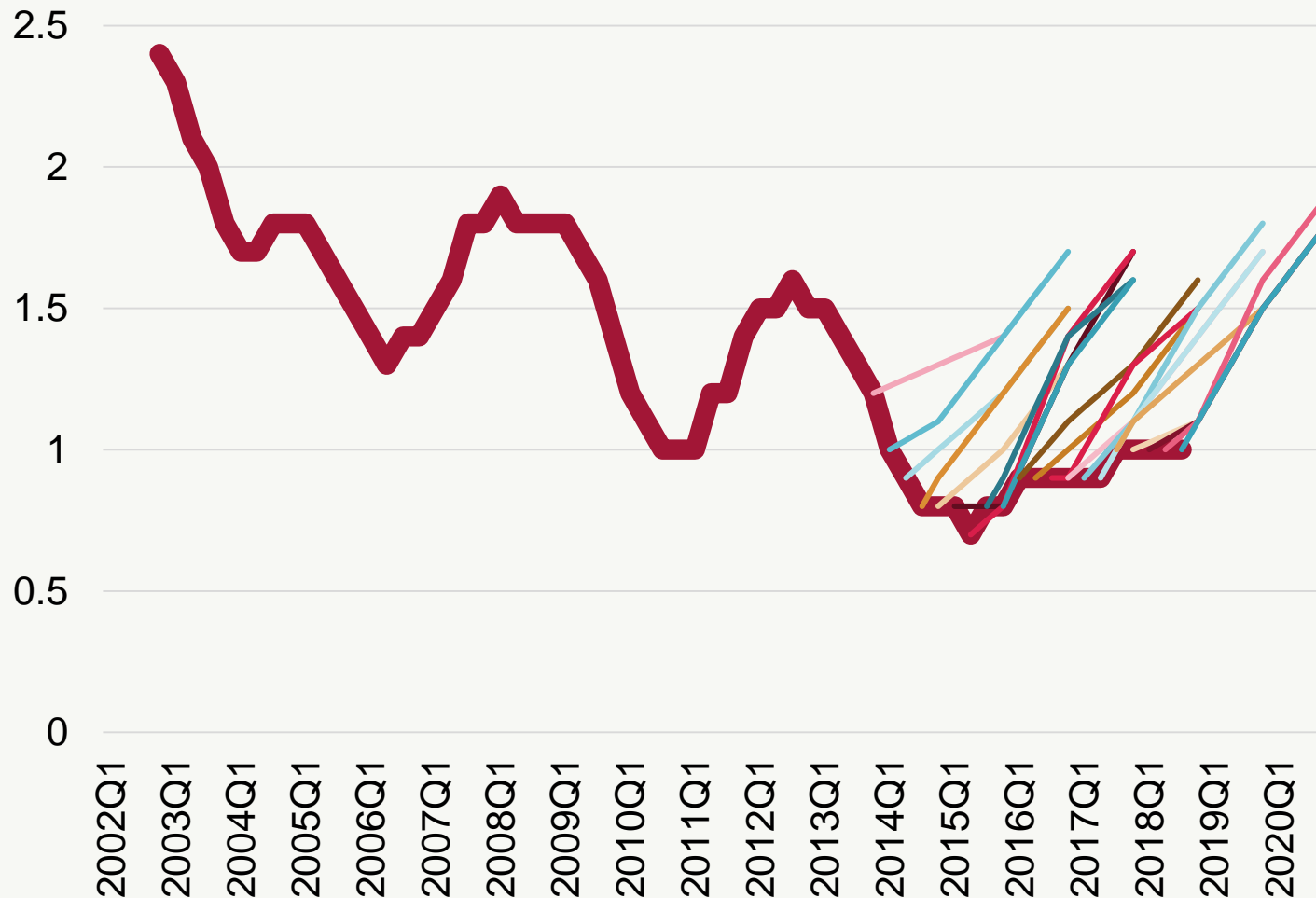
Bruegel and Corvinus University of Budapest

Macro Economy Research Conference: “Monetary Policy Normalization Ten Years
after the Great Recession”

Nomura Foundation

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The ECB's core inflation forecast has proved to be overly optimistic. Would it work this time?



Note:

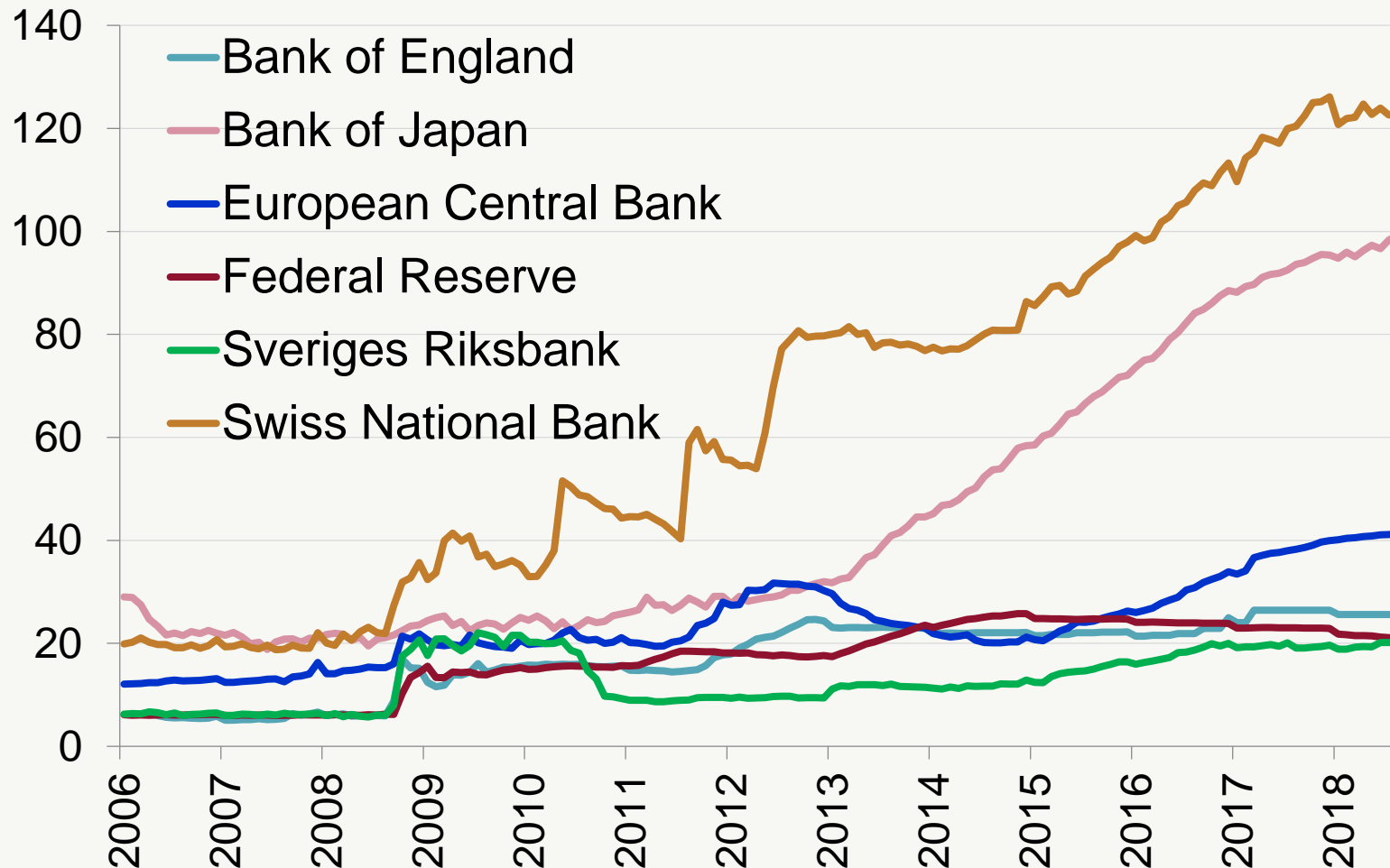
- Actual inflation is the thick red line (moving 12 months average rate of change)
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Motivation

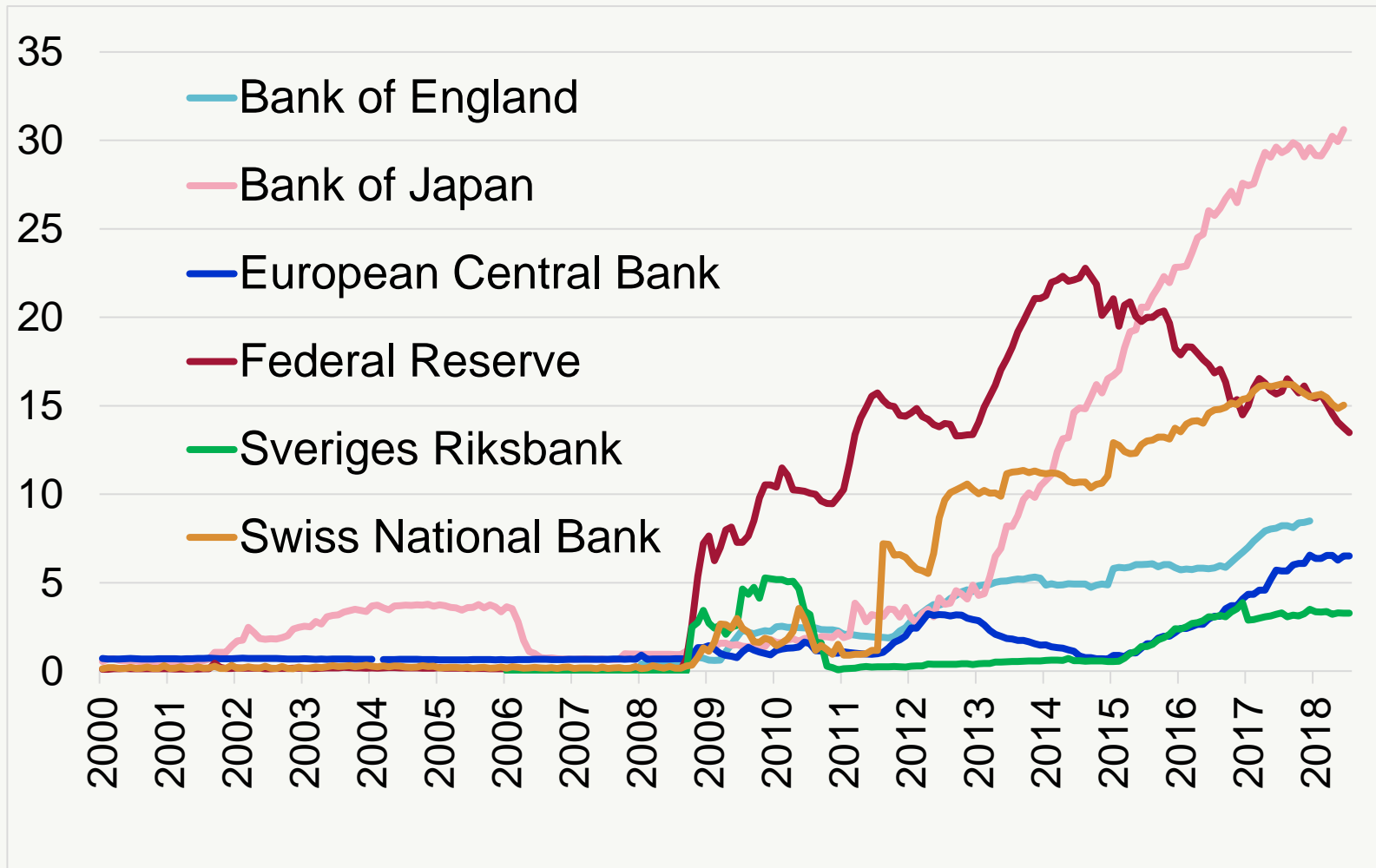
- Low/negative ECB interest rates and large expansion of balance sheet reflect non-standard monetary policies
- Inflation, the main objective of the ECB, reached 2% in summer 2018, but partly due to oil prices, while core inflation remains stable at 1%
- Inflation forecasts suggest an acceleration of core inflation in the coming years, yet the track record of inflation forecast is bad
- At the same time, the euro area remains rather heterogeneous with diverse inflation, growth and house price developments
- How to sequence monetary policy normalisation in the euro area? What lessons to draw from the monetary policy normalisation experiences of Sweden, US & UK?

Global comparison: central bank balance sheet (% GDP)



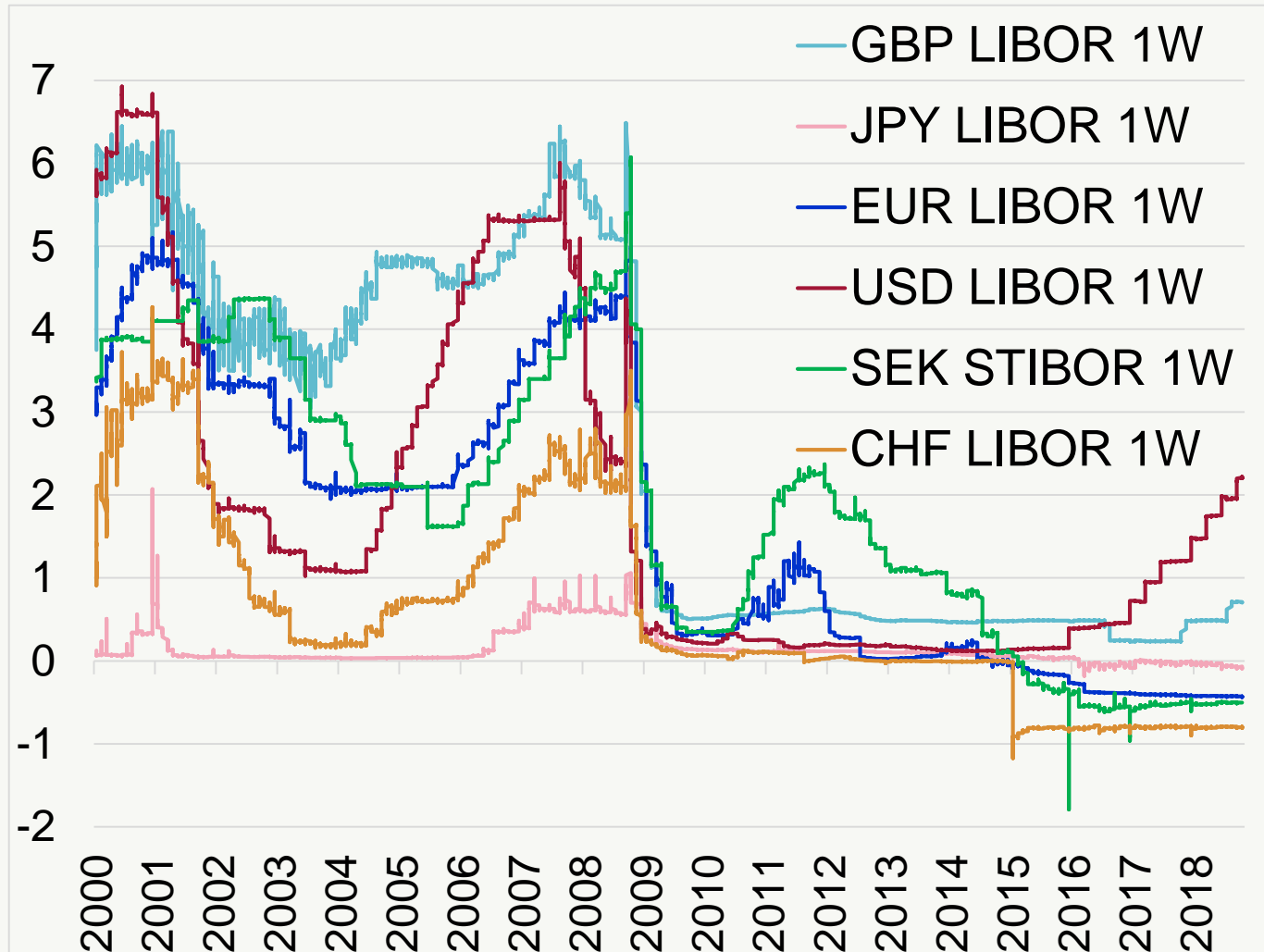
- Sizeable differences in pre-crisis balance sheet sizes
- Even more so after 2008
- Switzerland: main foreign currency purchase
- Others: purchase of various securities, including government bonds

Global comparison: banks' reserves at the central bank relative to banking assets (%)



- There is no reserve requirement in the UK and Sweden, so excess reserves cannot be calculated
 - We therefore show ratio of total banks' reserves to bank assets
- Euro area has in fact one of the lowest values

Global comparison: 1-week interbank interest rates (%), 2 Jan 2000 – 17 Oct 2018



- Federal Reserve: sizeable tightening since late 2015
- Bank of England: some tightening since late 2017
- Other 4: low interest rates remain

Note: I show the 1-week interbank rates and not central banks' interest rates, because for some central banks the importance of certain rates changed (e.g. for the ECB, the MRO rate was the main determinant of short-term market rates before 2008, since then the deposit rate is the main determinant).

Monetary policy normalisation questions

- Balance sheet: shrink or not? And to what level?
- Interest rates: when to raise and up to what 'new normal'?

Lessons from monetary policy exit mistakes of Sweden, the US and the UK

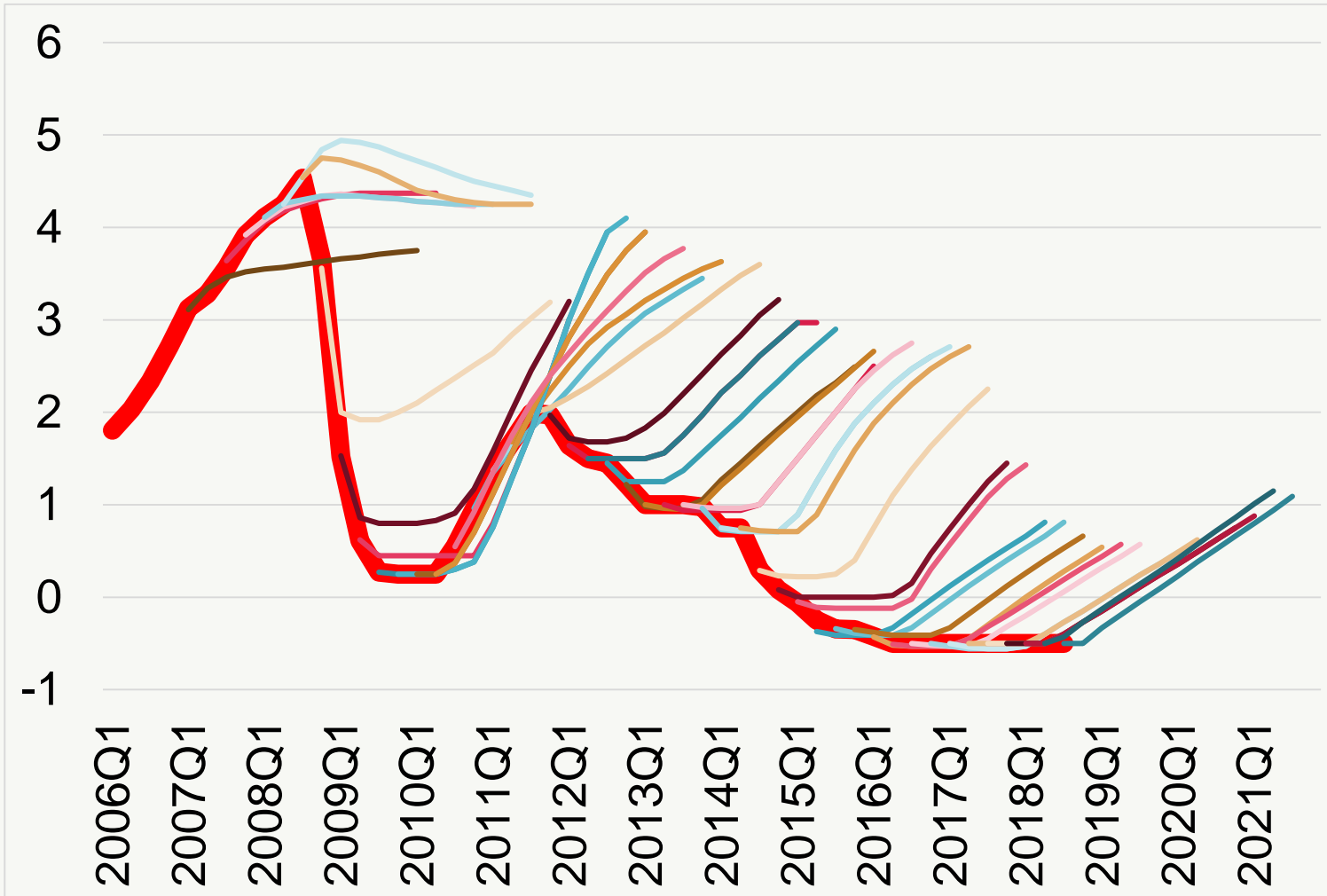
Sweden: premature monetary policy exit followed by massive tightening

- After Lehman Brothers collapse: main rate cut from 4.75% in October 2008 to 0.25% in July 2009
- July 2010 - July 2011: rate increase to 2% for financial stability reasons
- This premature monetary policy exit led to high costs in terms of excessively low inflation, overly high unemployment and a higher real debt burden for households
- After July 2011: rate cut to -0.5% & quantitative easing

Swedish interest rates, 2 January 2008 – 12 October 2018



The Riskbank's repo rate: actual (thick red line) and Riksbank forecasts

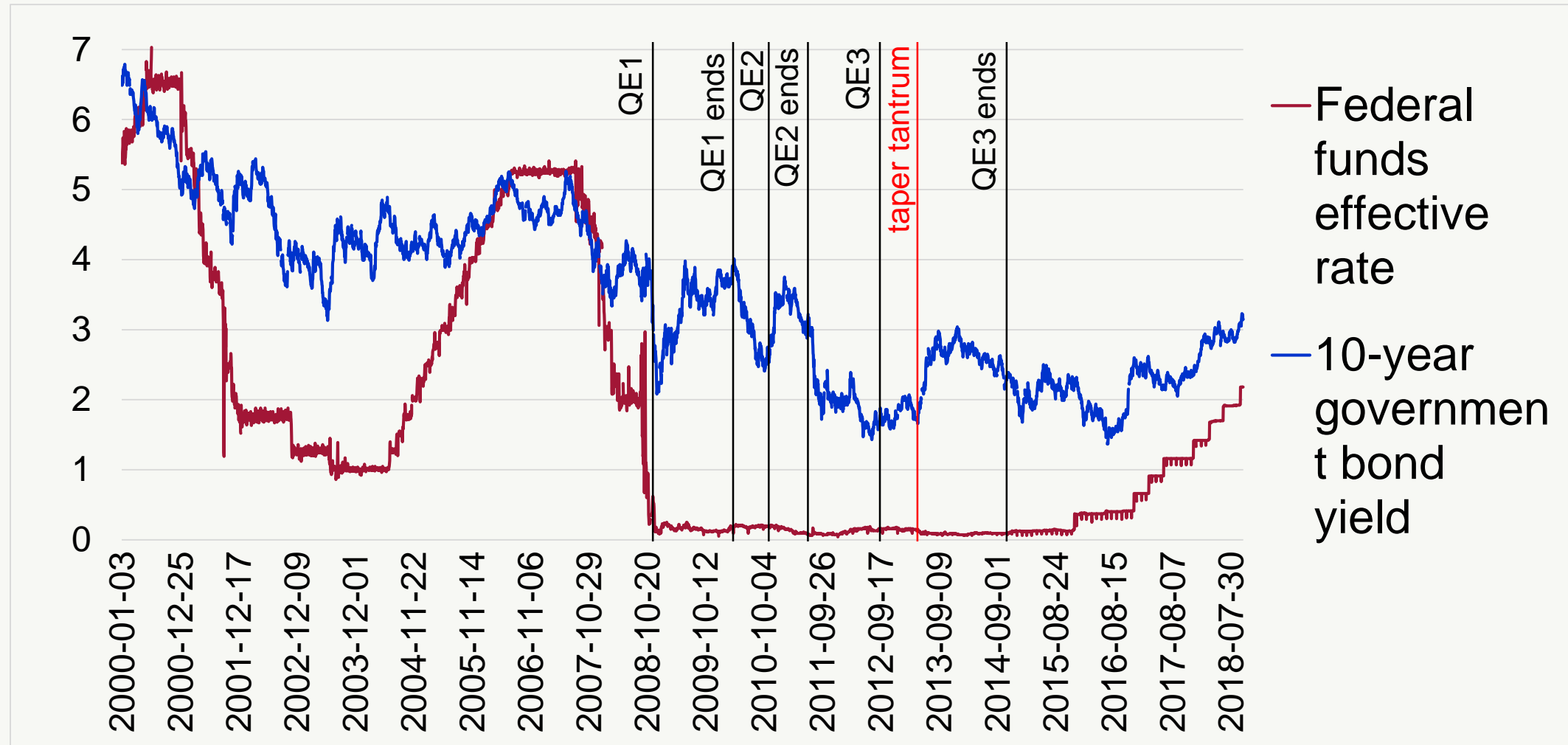


- Apart from the short period around 2010, the Riksbank interest rate guidance turned out to be grossly inadequate
- Noteworthy that the 10-year government bond yield has not increased despite the Riksbank's interest rate increase forecast and the ending of QE

Federal Reserve: ‘taper tantrum’ unnecessarily pushed-up the 10-year yield

- While QE3 was ongoing in the US, in early 2013 unemployment rate fell to 7.5%, nearing the 6.5% threshold which was announced earlier as the rate when the FED will start increase interest rates
- FOMC started to discuss “tapering” of QE in early May 2013: the 10-year yield increased from 1.7% to 3% in a few months – leading to a far larger tightening in financing conditions than the FED had intended
- Later, the 10-year yield has fallen back even below 1.7%, despite the actual tapering and ending QE and the first increase in federal funds rate in December 2015

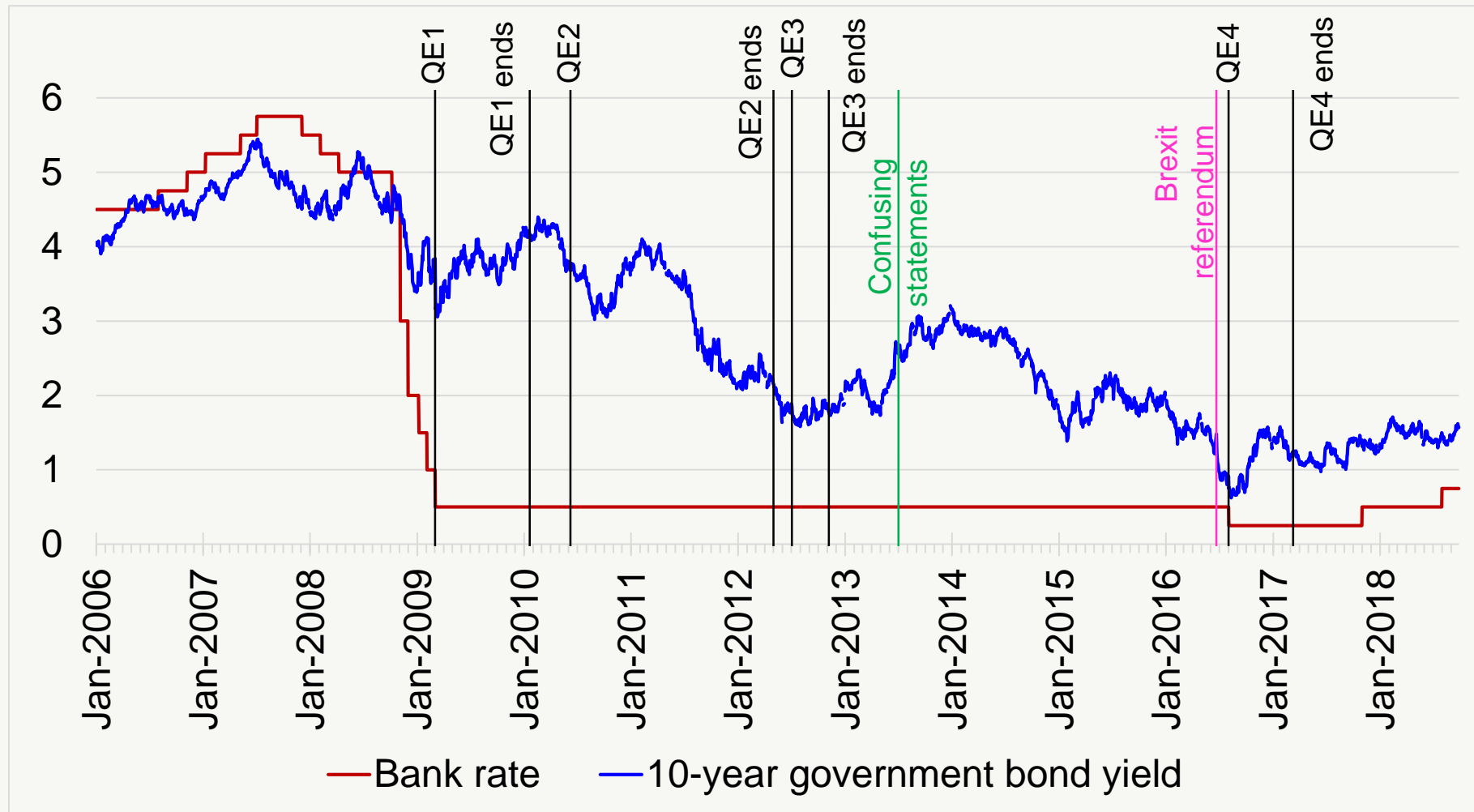
US interest rates, 2 January 2000 – 15 October 2018



Bank of England: some improper statements confusing markets

- July 2013: BoE releases a statement (an unusual move in the absence of a policy change) clarifying current policy and questioning whether the expected future rates were in line with economic developments
- Aug 2013: BoE introduces forward guidance, linking increase in interest rate to unemployment falling below 7%
- Feb 2014: BoE updates forward guidance, unlinking it from unemployment following the decrease of the unemployment rate below 7%
- June 2014: Mark Carney suggests that the interest rates could reach 2.5% in early 2017

UK interest rates, 2 Jan 2006 – 12 Oct 2018



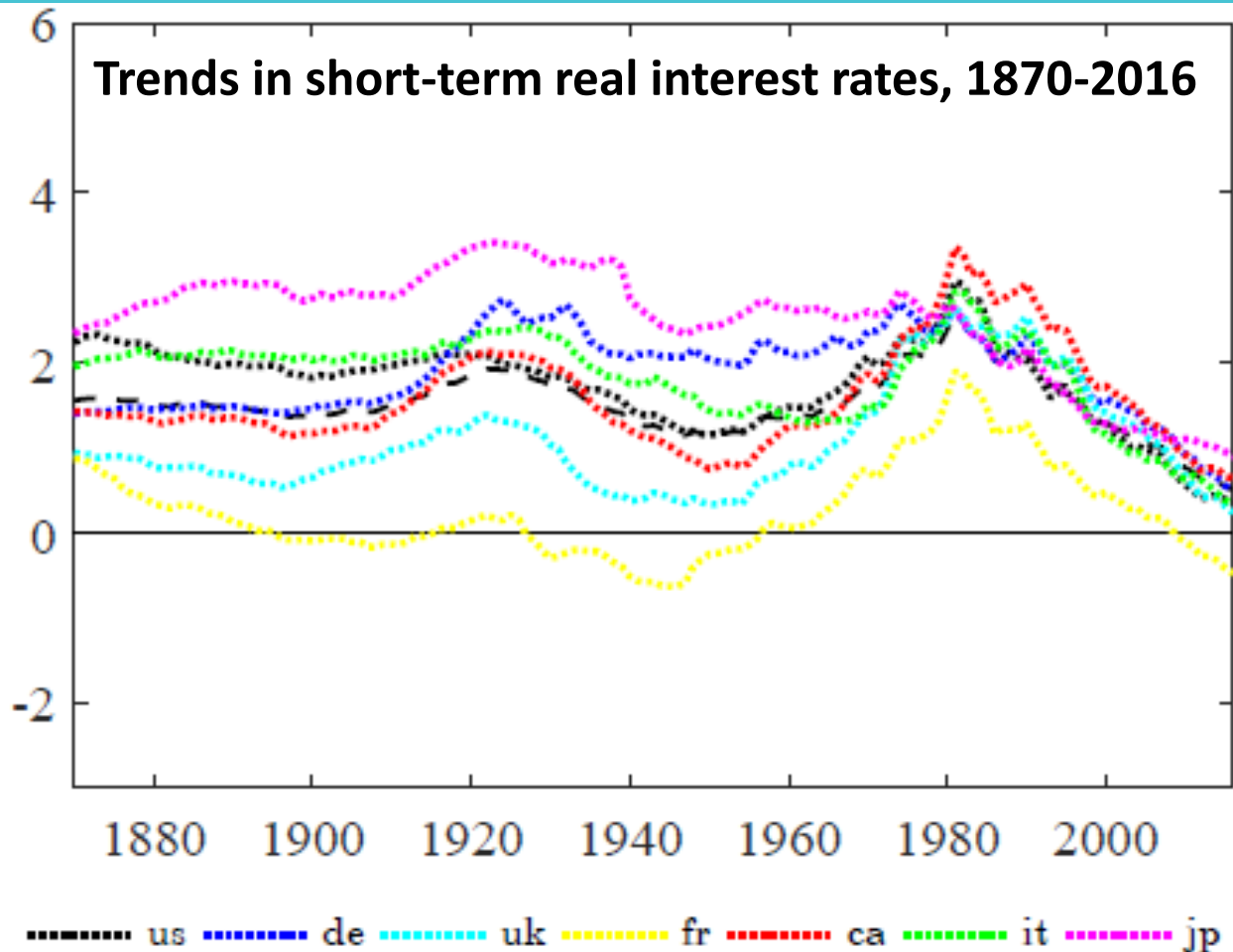
The Bank Rate is the single most important interest rate in the UK: the interest rate the Bank of England pays to commercial banks that hold money with the Bank of England.

Key conclusions from the QE exit experiences of the three countries

- Learn from the mistakes
- Clear forward guidance is crucial
- Premature exit has to be avoided
- Long-term interest rates have not increased when asset purchases have been stopped; not even after the first few rate increases (US, UK)

New normal in monetary policy?

Secular decline in global real interest rates



Explanations of the secular decline in global real rates by Del Negro *et al* (2018):

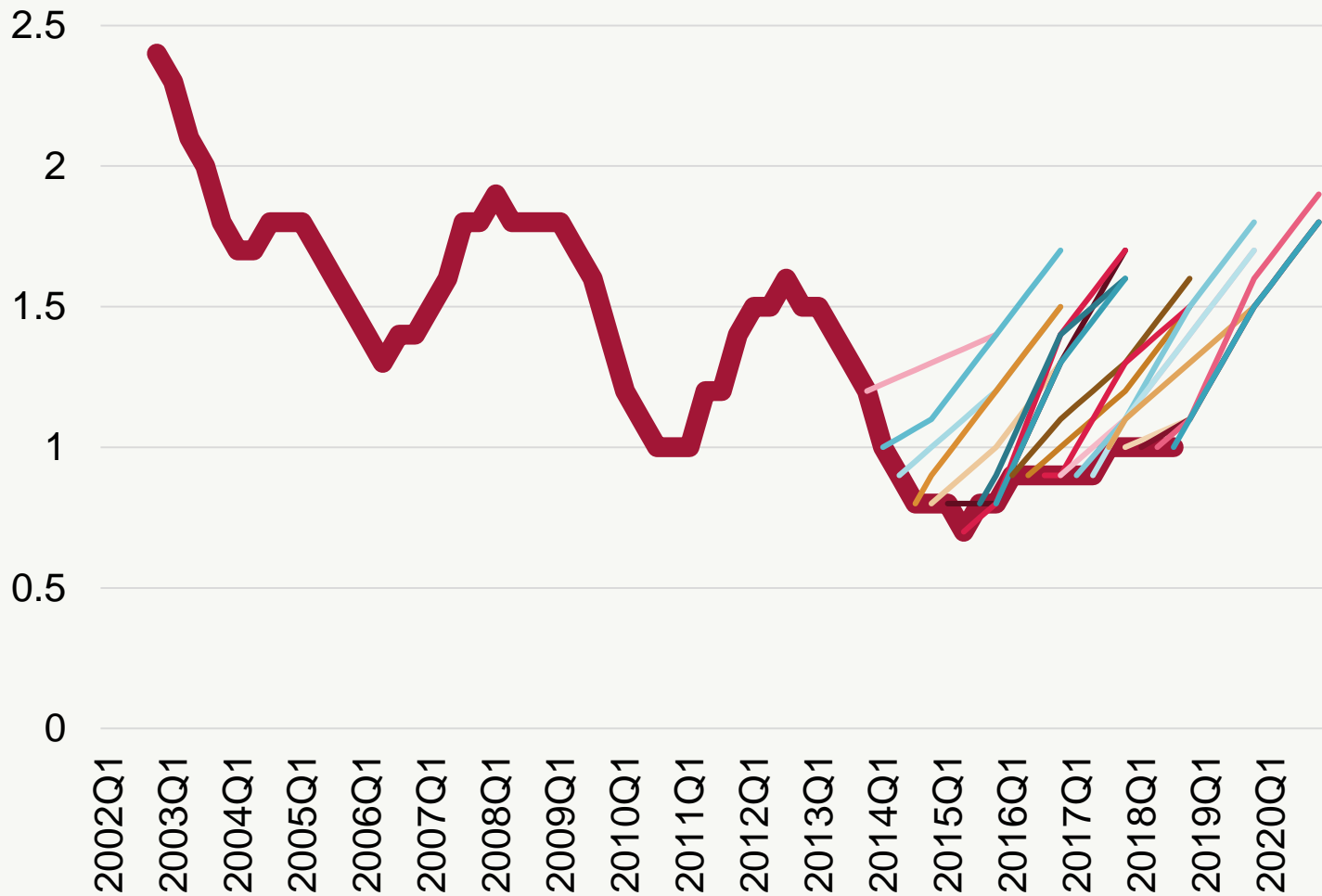
- Increase in the premium that international investors are willing to pay to hold safe and liquid assets (scarcity of safe assets in the context of a global saving glut)
- Lower economic growth

Central bank balance sheet

- No benchmark for ‘normal’ balance
- Balance sheet depends on the way monetary policy is conducted, on the exchange rate regime, past monetary policy actions, central bank tasks, profit distribution
- Arguments in favour of larger balance sheet:
 - (1) Lower equilibrium interest rate → zero lower bound will likely be reached more frequently → unconventional monetary policy would be used more regularly;
 - Larger balance sheet could (2) improve monetary transmission, (3) provide safe assets, (4) reduce banks’ incentives for excessive maturity transformation
- Arguments against larger balance sheet:
 - It exposes the central bank to financial risk and undue political influence

Monetary policy exit when the inflation outlook is uncertain

Recall: The ECB's core inflation forecast has proved to be overly optimistic. Would it work this time?



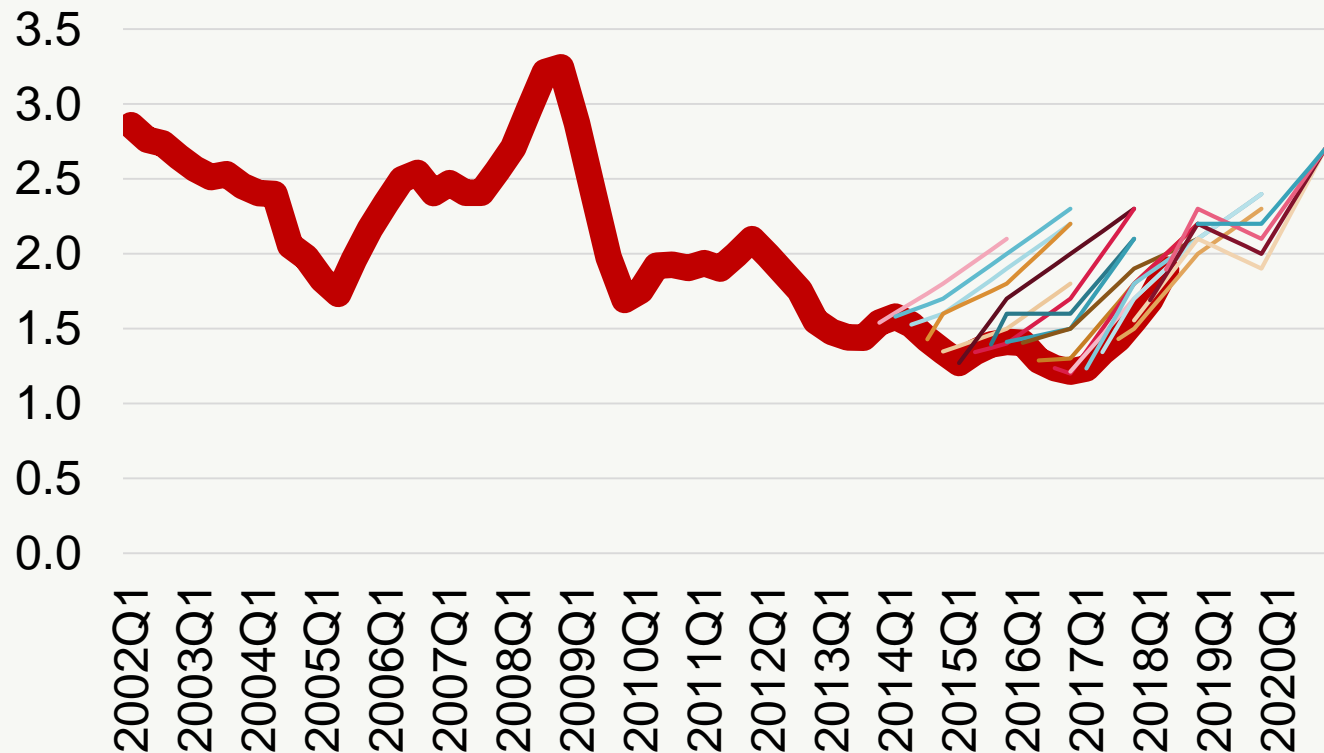
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Ray of hope: wage growth seems to accelerate

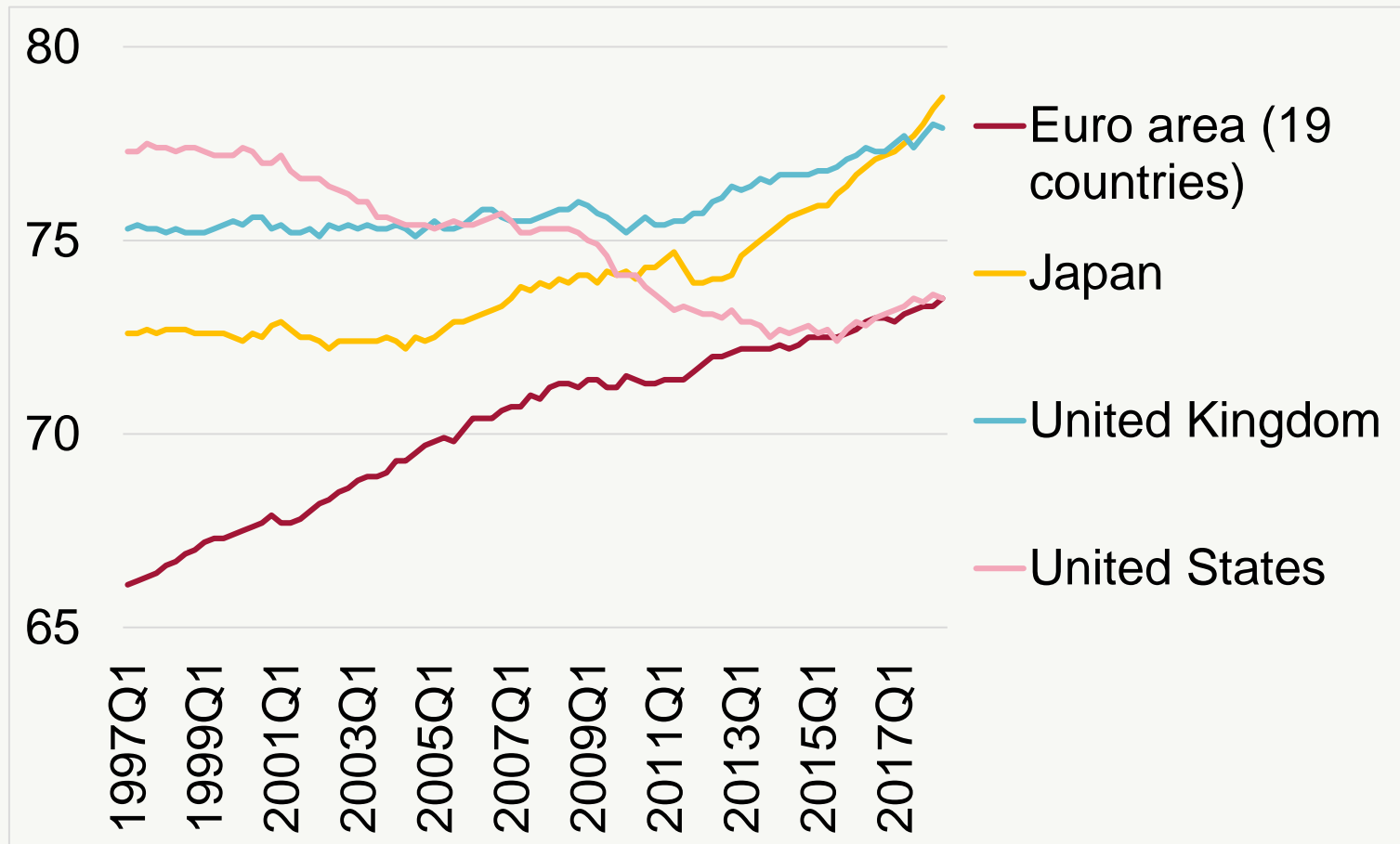
Compensation of employees in the euro area: actual data (thick red line) and ECB forecasts



- Following repeated failures in predicting wage growth, more recent data suggest a pick-up in wage growth

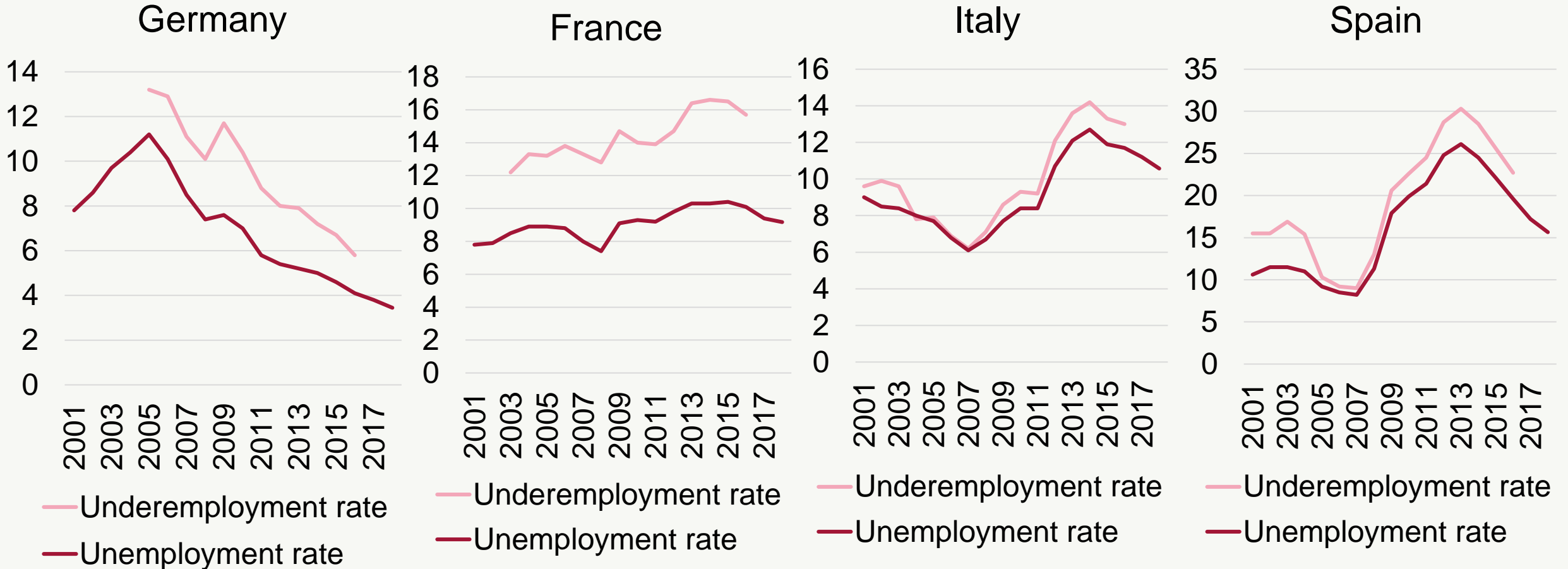
But: labour force participation continues to expand – good news for the people, bad news for inflation

Labour force participation rate (age 15-64, % of population)



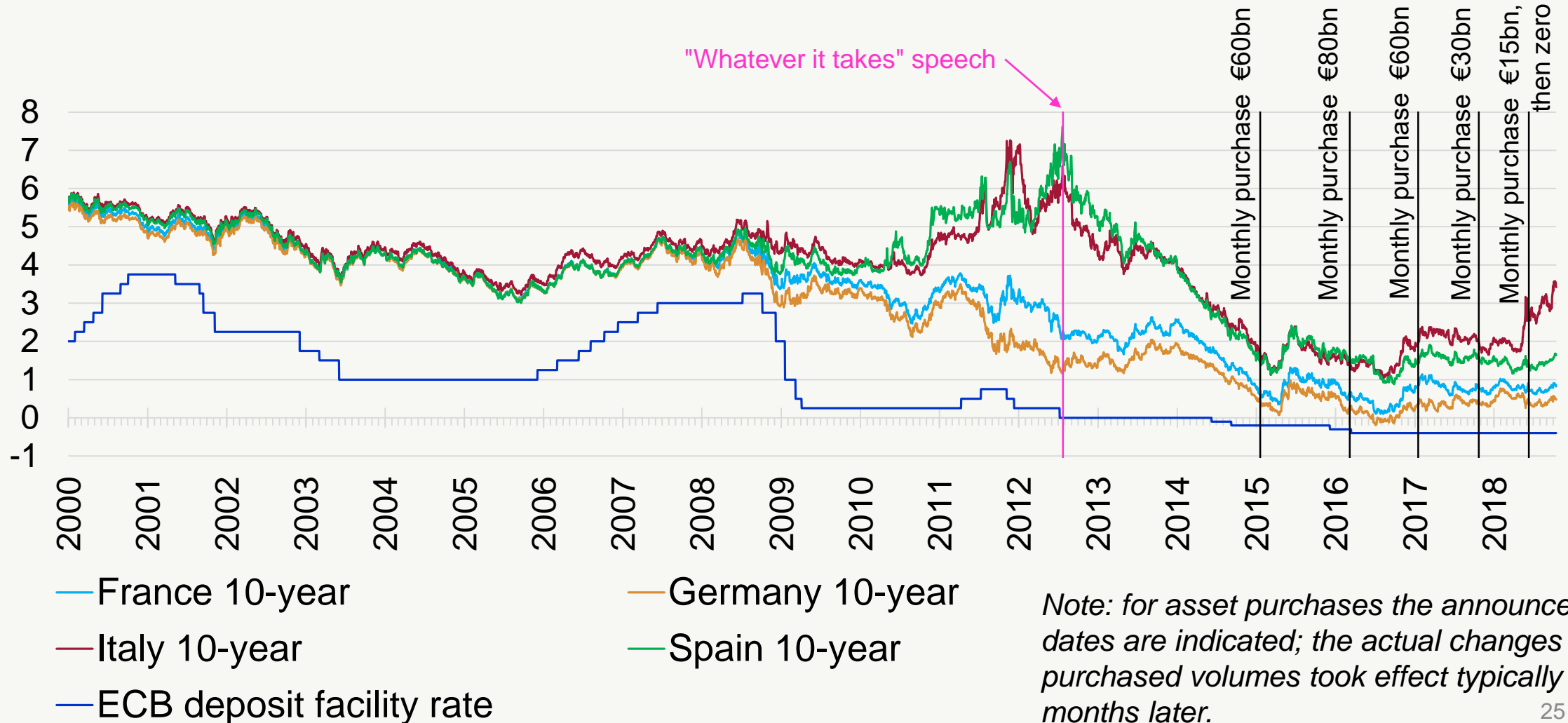
- While Americans were fleeing the labour market in 2000-2015, there has been a steady increase in euro area labour force participation

But 2: Underemployment is higher than unemployment, moderating wage growth



Sources: Underemployment: Bell, David N.F. and David G. Blanchflower (2018) 'Underemployment in the US and Europe', NBER Working Paper No. 24927; Unemployment: Eurostat; 2018 data refer to the average of January – August 2018.

ECB deposit facility interest rate, main asset purchase announcement dates and 10-year government bond yields of four countries



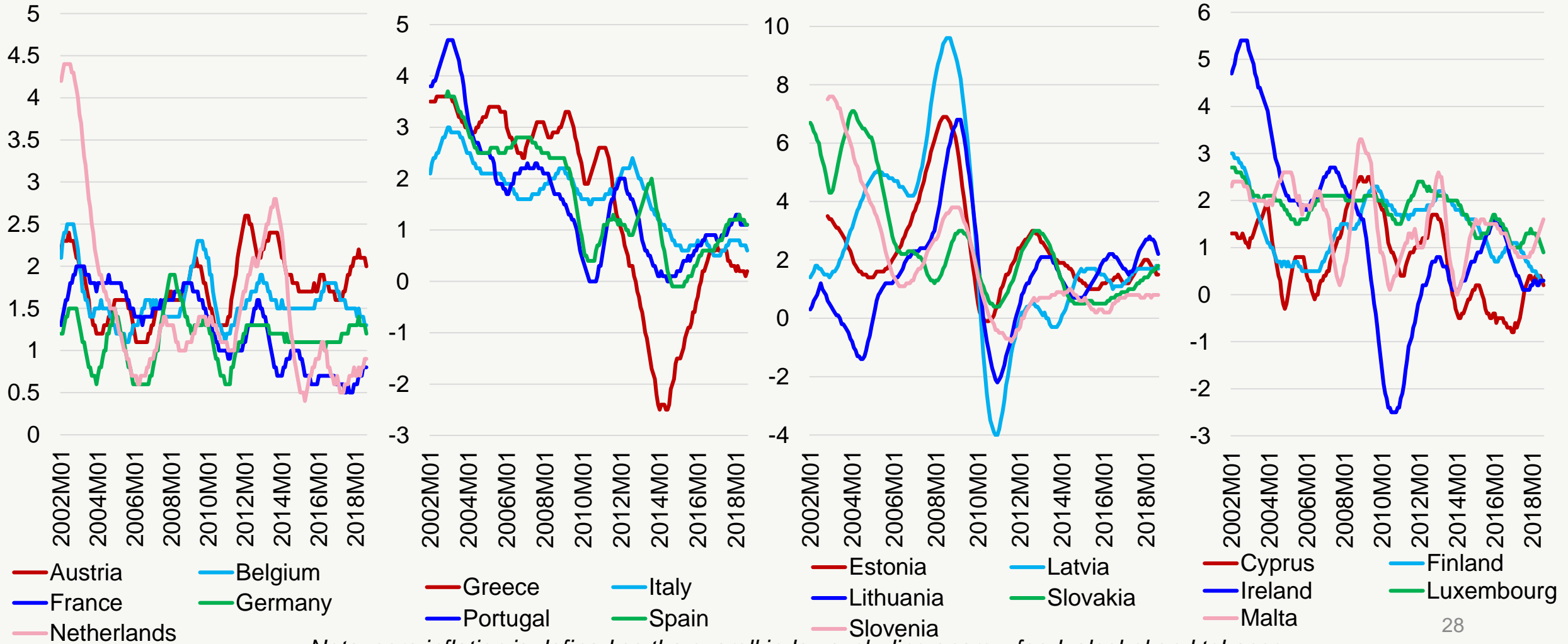
ECB interest rate lift-off

- Key conclusion from other central banks:
 - Ending asset purchases might not increase interest rates (especially if maturing asset holdings are reinvested)
 - The key issues is the start date and the expected path of interest rate increases
 - Premature monetary policy exit is dangerous
- My advise is to wait with interest rate increase until core inflation has actually reached a sufficiently high level. Since inflation has undershoot for long, prolonging rate increase to after a period of inflation overshooting would be desirable. In my view, the ECB's current forward guidance is insufficient:
 - *“The Governing Council expects the key ECB interest rates to remain at their present levels at least through the summer of 2019, and in any case for as long as necessary to ensure the continued sustained convergence of inflation to levels that are below, but close to, 2% over the medium term.”* (13 September 2018 ECB press release)

The euro area is heterogeneous,
financial stability risks vary across
countries

Core inflation: large heterogeneity in the euro area

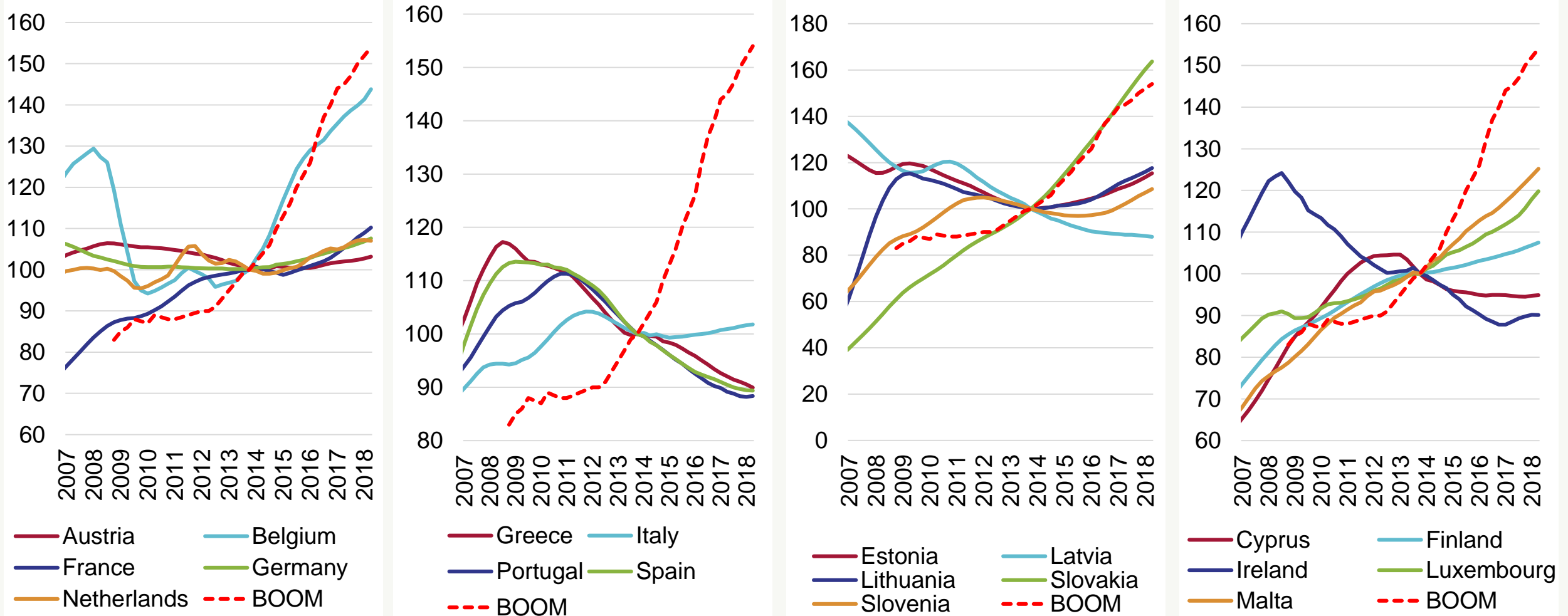
Core inflation (moving 12 months average rate of change)



Note: core inflation is defined as the overall index excluding energy, food, alcohol and tobacco

Credit growth: large heterogeneity in the euro area

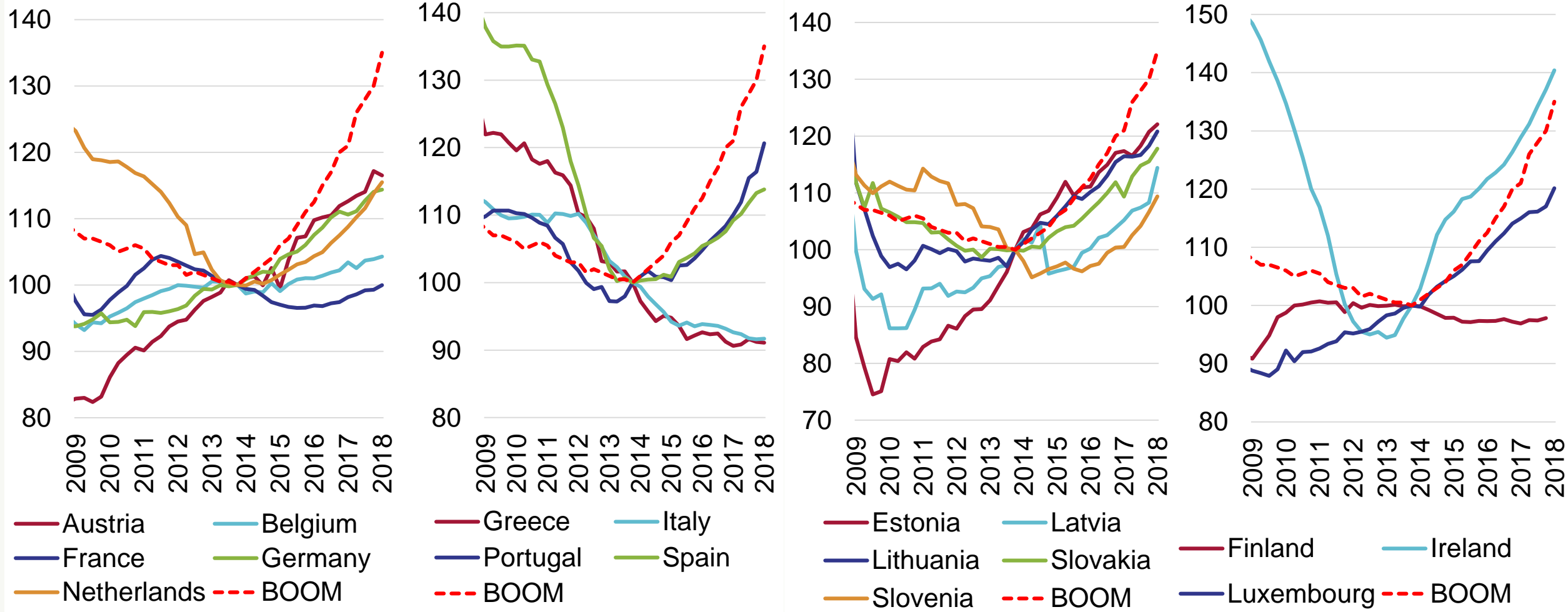
Bank lending to households at constant prices (2013Q4=100)



Note: BOOM refers to credit growth during historical episodes of housing booms.

House price developments: large heterogeneity in the euro area

Real house price index (2013Q4=100)



Note: BOOM refers to house price increases during historical episodes of housing booms.

Should monetary policy aim to support financial stability?

- Conceptually, monetary policy tools are ill-suited to fostering financial stability goals
- Problem is even more severe in the heterogeneous euro area
- Macroprudential policy should play a major role
- Current macroprudential assessments: the overall risk to financial stability remains low, though there are certain vulnerabilities
- In some euro area countries certain vulnerabilities have already led to measures, like capital buffer for systemically important institutions, countercyclical capital buffers (CCyBs), and debt-to-income (DTI) ratio limits and loan-to-value (LTV) ratio limits

Five main take-aways

1. Premature monetary policy exits involves major risks: careful forward guidance is needed
2. In the new 'normal' central bank balance sheet policies will likely become part of the regular toolkit, especially if the natural rate of interest remains low
3. Stopping asset purchases would not increase long-term rates
4. The inflation outlook in the euro area is very uncertain: better to wait with interest rate increase till core inflation overshoots
5. The euro area is very heterogeneous: monetary policy cannot address financial stability concerns; instead, macroprudential policy should have major role

Thank you for your attention

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