



The Changing Nature and Geography of Global Finance: Implications for the Conduct and Design of Monetary Policies

Fiorella De Fiore (Bank for International Settlements)

The views expressed here are those of the author and should not be attributed to the BIS

Outline

1. Challenges for monetary policy (MP) in the post-GFC environment
2. Implications for MP frameworks in AEs

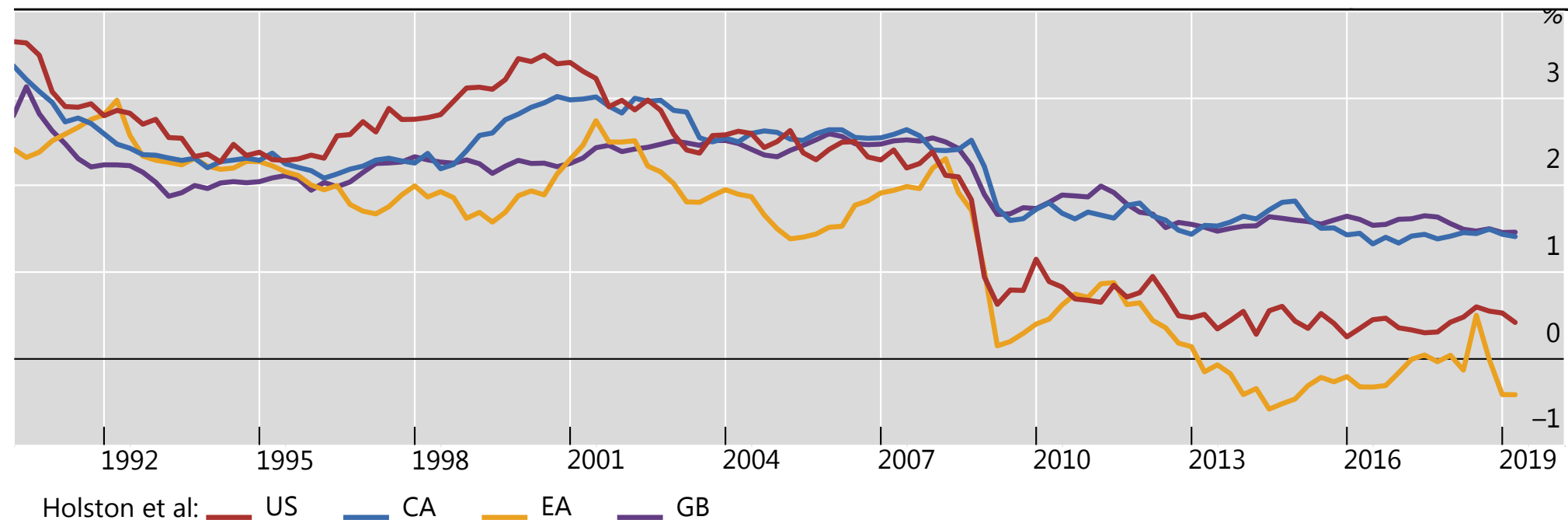
1. Challenges for MP in the post-GFC environment

Low “natural” real rates

- Secular decline in real “natural” rates (Holston et al., 2017)
- Contributing factors
 - Low growth/productivity, possibly due to demographic shifts (Fisher, 2017)
 - Convenience yield, uncertain productivity (Del Negro et al., 2019; Marx et al., 2017)
- Higher probability of hitting the ZLB
 - Limited room to stabilize economic activity in downturns
 - Risk of de-anchoring of π expectations

Low “natural” real rates increase the probability of hitting the ZLB

Cross-country comparison of natural rate measures



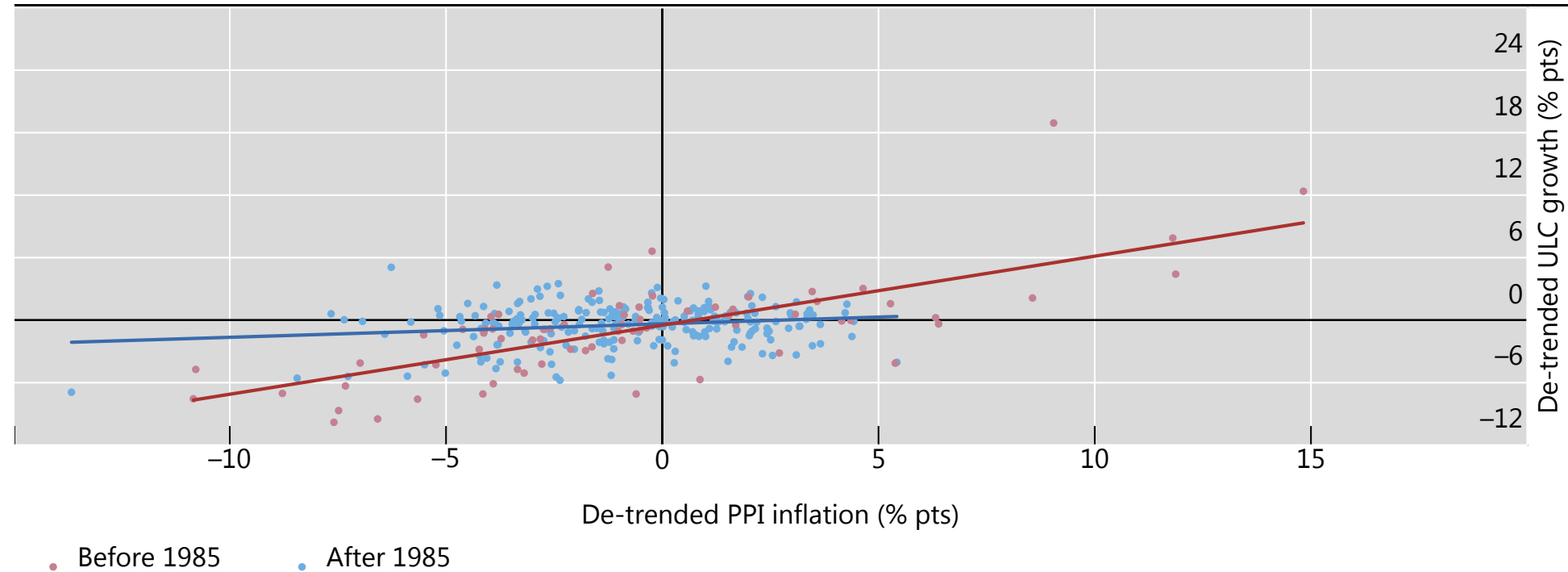
Sources: K Holston, T Laubach and J Williams, “Measuring the natural rate of interest: international trends and determinants”, Federal Reserve Bank of San Francisco, *Working Papers*, November 2016; Bloomberg; national data; BIS calculations.

Persistently low inflation

- Flattening of Phillips curve: weaker correlation between measures of slack and inflation.
- Factors contributing to low inflation
 - Success of IT regimes in anchoring expectations
 - Larger slack than previously expected (lower natural rate of unemployment)
 - Structural changes (ie globalization and entry of low cost producers, wage bargaining power)
- More difficult to stabilize π by changing interest rates and to hit the target

Limited ability to steer inflation under flattened Phillips curve

The transmission of ULC to prices has weakened



G7 economies; annual data from 1970 to 2018.

Source: BIS, Annual Economic Report 2019, Chapter 1.

Digital/crypto currencies

- Private digital/crypto currency (DC) is a substitute for cash and can weaken effectiveness of MP
- Libra: stable currency fully backed by basket of safe assets
- Muted interest rate channel: lower pass through of policy rate to saving rate if
 - Savings channeled to DC
 - Return on DC depends on international basket of safe assets or currencies
- Muted bank lending channel
 - Higher savings through DC reduce deposit funding and bank intermediation
- Further downward pressure on interest rates if DC increases demand for safe assets

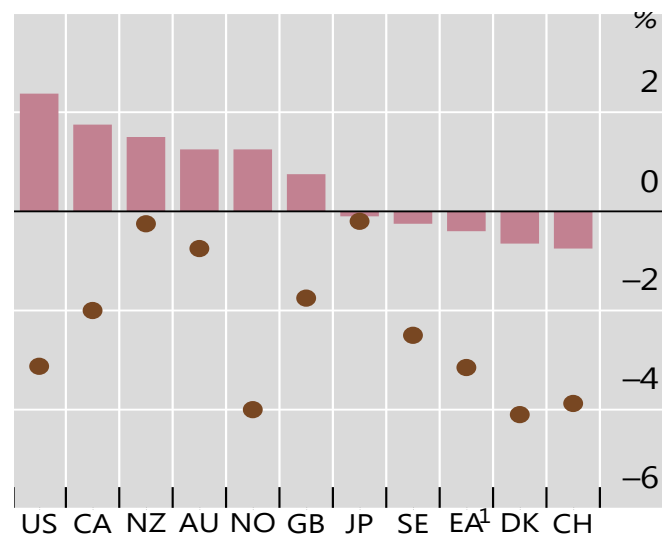
2. Implications for MP frameworks in advanced economies

Option 1: Expanding the toolkit to use UMPs in normal times

- UMPs proved effective in complementing interest rate policy at the ZLB during GFC
 - FG, negative rates, QE, YCC, (targeted) refinancing operations
 - Possible additional tool: Central Bank Digital Currency (CBDC)
 - Interest on digital reserves may limit demand for private DC and safeguard MP effectiveness
 - CBDC may also facilitate negative interest rates policy
- UMPs also created distortions during GFC
 - Safe asset scarcity
 - Drying up of unsecured money markets
 - Risk of losses for the CB
- Little knowledge about effectiveness of UMPs in normal times
 - Decreasing returns to scale (lower effectiveness with lower risk)
 - Reduced space also for UMPs

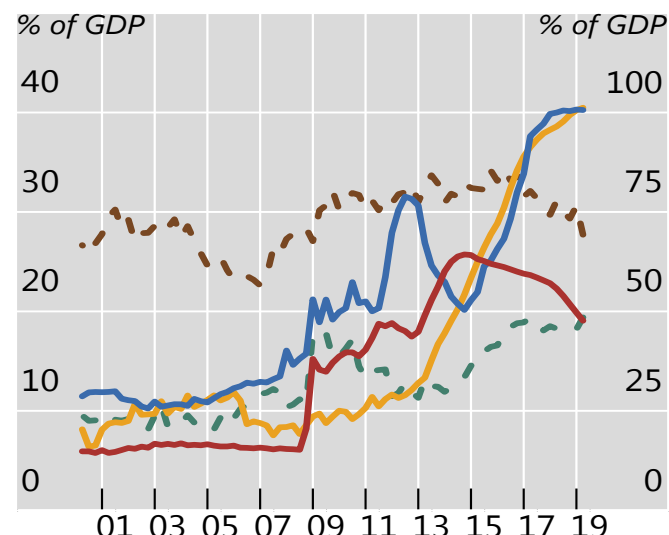
Limited space and/or effectiveness reduce scope for UMPs

Policy rates



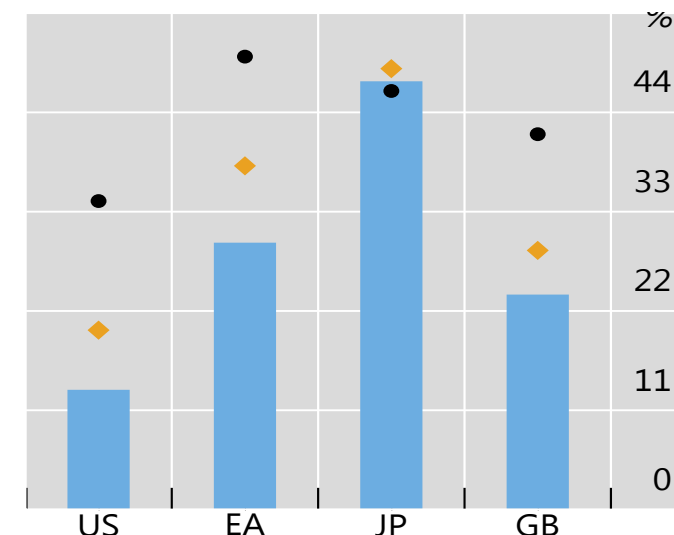
■ Current rate
● Current rate less 2000-04 cut

Central bank balance sheets²



Lhs: — US — EA — JP — Other AEs — EMEs
Rhs: — JP

Share of government bonds held by central banks³



■ Current
◆ To achieve historical minimum yield
● To achieve zero yield

¹ Deposit facility rate as policy rate. ² Total assets. Median for eight AEs and 23 EMEs or fewer depending on data availability in time. ³ Shares of central banks' bond holdings relative to total government debt securities, and counterfactual estimates of holdings needed to attain both historical minimum and zero 10-year yields. See Annex A for details. For the euro area, weighted average of DE, FR, IT and ES based on capital keys; debt securities purchased under the PSPP.

Sources: Bank of Japan, *Flow of Funds Accounts*; Board of Governors of the Federal Reserve System; ECB; United Kingdom Debt Management Office; US Department of the Treasury; IMF, *International Financial Statistics*; Bloomberg; Datastream; BIS policy rate statistics; national data; BIS calculations.

Option 2: “Make-up” strategies as a way to better anchor expectations

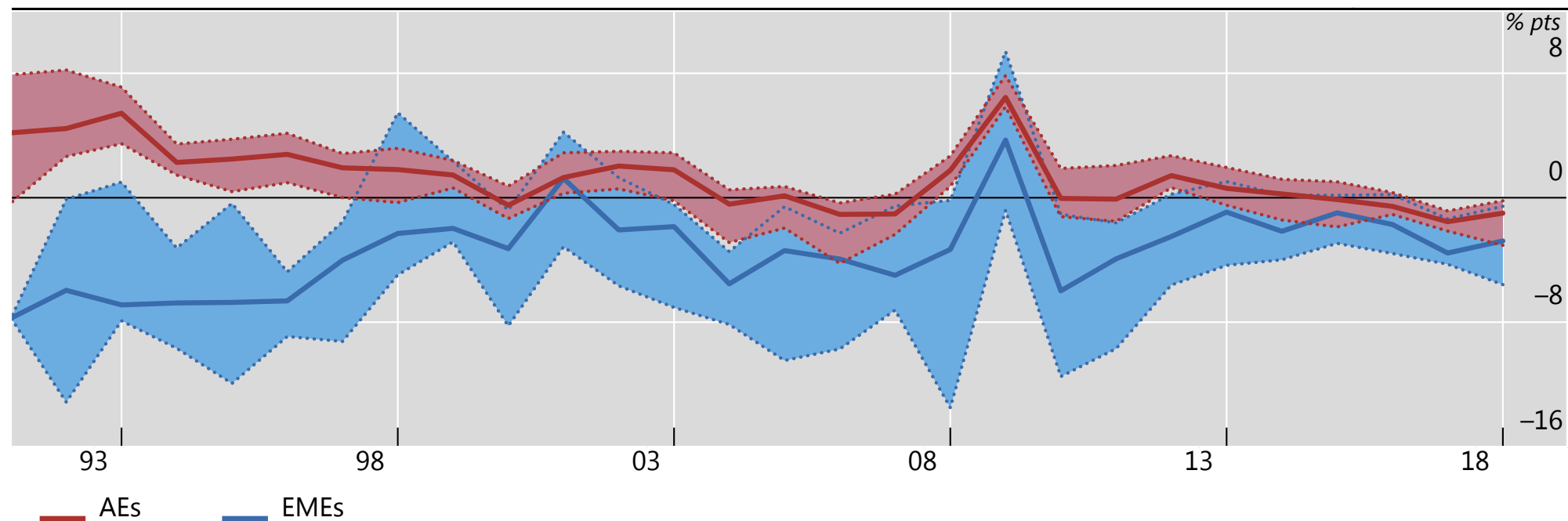
- MP frameworks in AEs share important features of flexible π targeting
 - Policy rate such that forecasted inflation and output at target over given horizon
 - Overshooting tolerated only occasionally – bygones are bygones
- “Make-up” strategy allow for protracted overshooting to compensate past deviations from target
 - Flexible or temporary P-level targeting, average π targeting
 - Desirable automatic stabilization properties for π expectations: when P or π fall below target, agents expect it to remain above in the future
- Challenges
 - Credible commitment?
 - What if inflation cannot be increased?
 - Effectiveness when agents learn and π expectations are sluggish

Option 3: Co-ordination of monetary, fiscal and macro-prudential policies

- Limited space for MP, uncertain effectiveness of “make-up” strategies
 - Scope for coordination of alternative policies
- Macropru policies measures can be usefully activated to
 - Limit the build-up of financial vulnerabilities in periods of “low for long” MP
 - Release buffers to cushion credit contraction in downturns
- Fiscal policy
 - Effectiveness of fiscal policy is enhanced at or close to the ZLB
 - Low yields have created some fiscal space that could be used in countries with low debt/GDP

Fiscal space: effective cost of debt below nominal GDP growth

Median difference between government effective interest cost of debt and nominal GDP growth



The dotted lines represent upper and lower quartiles.

Sources: IMF, *World Economic Outlook*; OECD, *Economic Outlook*; Bloomberg; Datastream; BIS calculations.

Conclusions

- Challenging times for MP
- MP can to some extent offset the ZLB with targeted UMPs or adopting make-up strategies
- But during the GFC the ZLB could not (or was not) made irrelevant
- Looking ahead:
 - MP has some (compressed) space to respond to a slowdown
 - Macropru and fiscal policies could play a role in case of future downturns

References

- Annual Economic Report 2019. Bank for International Settlements.
- Global Findex database 2017. World Bank.
- Del Negro, M., D. Giannone, M. Giannoni, and A. Tambalotti. 2019. "Global trends in interest rates." *Journal of International Economics* 118.
- Fischer, S. 2016. "Why Are Interest Rates So Low? Causes and Implications." Speech at the Economic Club of New York on October 17.
- Holston, K., T. Laubach and J. Williams. 2017. " Measuring the natural rate of interest: International trends and determinants." *Journal of International Economics*, Volume 108, Supplement 1.
- Marx, M., B. Mojon, and F. Velde. 2019. Why have interest rates fallen far below the return on capital? BIS Working Papers, No 794, 09 July.