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

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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 $\pi$ expectations
Low “natural” real rates increase the probability of hitting the ZLB

Cross-country comparison of natural rate measures

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 (i.e., globalization and entry of low cost producers, wage bargaining power)

- More difficult to stabilize $\pi$ 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.

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

Central bank balance sheets

Share of government bonds held by central banks

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 $\pi$ 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 $\pi$ targeting
  - Desirable automatic stabilization properties for $\pi$ expectations: when $P$ or $\pi$ 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 $\pi$ 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

• 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.