Effective Monetary Policy with Lower Neutral Rates

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Bank of Canada, September 2017

Introduction

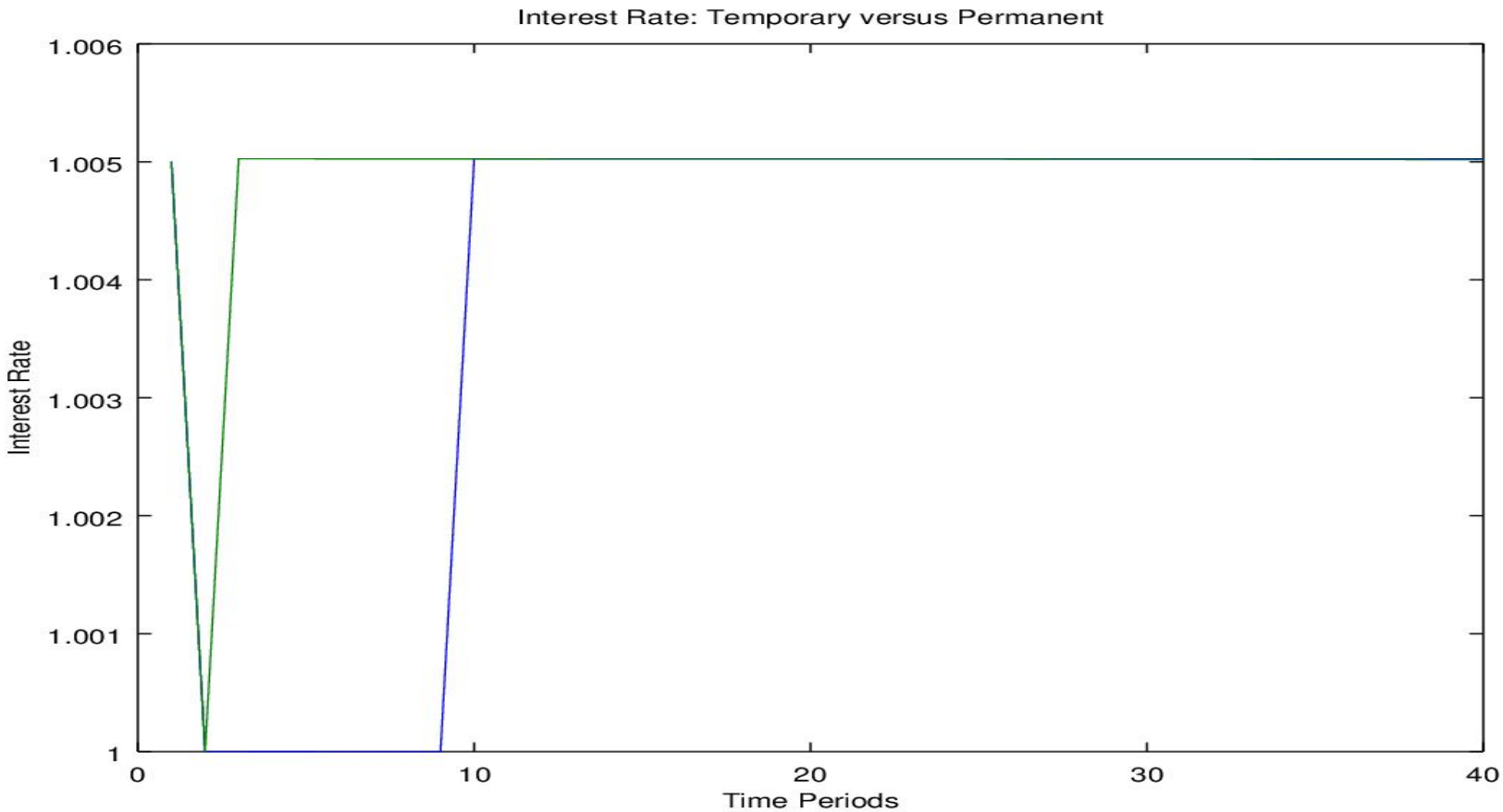
- Nine years since the beginning of the Great Recession, seven or eight years since recovery began
- Sluggish growth, most central banks undershooting inflation targets since 2012
- Lower neutral interest rates
- Greater likelihod of hitting effective lower bounds in the future (cf. Kiley and Roberts 2017)
- Which types of UMP will be most effective to fight future crises?

Introduction (cont.)

- Message: QE's the ticket
- Message: QE has been ineffective because **it hasn't been given a fair chance**
- I want to cover the following ground
  1. Why other UMPs are not likely to be effective
  2. Why QE as practised during the Great Recession and the recovery hasn't worked well
  3. What's needed to make QE effective
  4. Counterarguments to the objections to QE
  5. Bottom line: (1) effective QE means a permanently higher path for MB/balance sheet, (2) level targeting would help make this credible/effective

Quiz

- Which interest rate path reflects is the loosest monetary policy?



UMP 1: Forward Guidance

- Interest rates a **bad** indicator of monetary policy stance
- Friedman (1997): "Low interest rates are generally a sign that money has been tight, as in Japan; high interest rates, that money has been easy."
- FG should be a regular tool of policy in the form of conditional interest rate forecasts
- Announcing a rate at ELB for longer can't push longer rates much below 0
- During a crisis the natural rate can be highly negative. Cúrdia (2015): -4% during Great Recession in US

UMP 2: Negative Rate Policy (NIRP)

- Lower bound no longer zero: central banks can tax reserves
- Already implemented in Sweden, Denmark, Switzerland, ECB
- Natural rate in crises likely to be much lower than policy rate can be pushed
- Hence the push to abolish cash (Sveriges Riksbank, Rogoff, etc.)
- Likely to have unintended consequences

UMP 3: QE As Practised

- Thornton (2015): most arguments for QE appealed to the "interest rate channel"
- Little empirical support for the "preferred habitat" theory of rates of return $\Rightarrow$ effects either not significant or measured in tens of basis points
- Other channels have been mentioned. **Not** the **expected inflation** channel

UMP 3: QE As Practised (cont.)

- For example, Governor Poloz (2015) in a speech discussed how QE (or LSAP) affect the economy

UMP 3: QE As Practised (cont.)

1. "First, they create new liquidity in the banking system, which can increase the availability of credit . . . "
2. "Second, large-scale asset purchases tend to lower the interest rates on the purchased assets, and on other types of debt of similar duration, which in effect flattens the yield curve, bringing longer-term interest rates down closer to short-term interest rates . . . "
3. "Third, such purchases of assets tend to put downward pressure on the exchange rate ..."

UMP 3: QE As Practised (cont.)

- QE **has always been intended to be temporary**
- Temporary QE **should have** weak effects. Bernholz (1988), Calomiris (1988), Sumner (1993)

UMP 3: QE As Practised (cont.)

- Projections by researchers at NY Fed (2015):

Effective QE

- Old (and new) idea: to be effective, QE must be **permanent**
- Higher level or **path** for the monetary base
- The old idea really just comes from long-run monetary neutrality

Effective QE: Juicy Quotes

- Friedman and Schwartz (1963) describe the mechanism. "Let us now suppose that an unexpected rise to a new level occurs in the rate of change in the money stock, and it remains there indefinitely ..."

Effective QE: Juicy quotes (cont.)

- Woodford (2012): "If, instead, one were to assume a permanent increase in the size of the monetary base, and assume that it is immediately understood by the everyone in the economy that such a permanent change in policy has occurred, then such a policy would be predicted to have an immediate postive effect on economic activity during the period in which the lower bound binds . . ."

Effective QE: Juicy quotes (cont.)

- Krugman (1998): "A monetary expansion that the market expects to be sustained (that is, matched by equiproportional expansions in all future periods) will always work, whatever structural problems the economy might have; if monetary expansion does not work – if there is a liquidity trap – it must be because the public does not expect it to be sustained."

Objections 1

- Coordination between the monetary and fiscal authorities required?
- No. Buiter (2014)
- Through asset purchases from non-banks the central bank can affect the intertemporal budget constraint of the govt unilaterally. It's then up to the govt to decide what to do about it

Objections 2

- Inflation expectations might become unanchored? A permanent expansion can always be followed by another permanent expansion
- This suggests **symmetric level targeting** as a solution
- Level targeting has 2 other huge advantages.
  1. Automatically makes MP credible. Vestin (2006)
  2. Gets rid of multiple LRE. Ambler and Lam (2016)

Objections 3

- Targeting **headline inflation** would mean, for example, fighting an inflation induced by a positive oil price shock
- This suggests targeting a different index
- Target a "sticky-price CPI" such as the one calculated by the Atlanta Fed

Summary

- Make monetary policy effective by using effective QE
- Make QE credible and effective by using level targeting
- Remove the dangers (and fears) of hyperinflation by level targeting
- corollary to Friedman: low interest rates can mean monetary policy has been tight in the past, and can also possibly mean that monetary policy is **expected to be tight in the future**