Current Challenges for the Conduct of Monetary Policy in the Euro Area

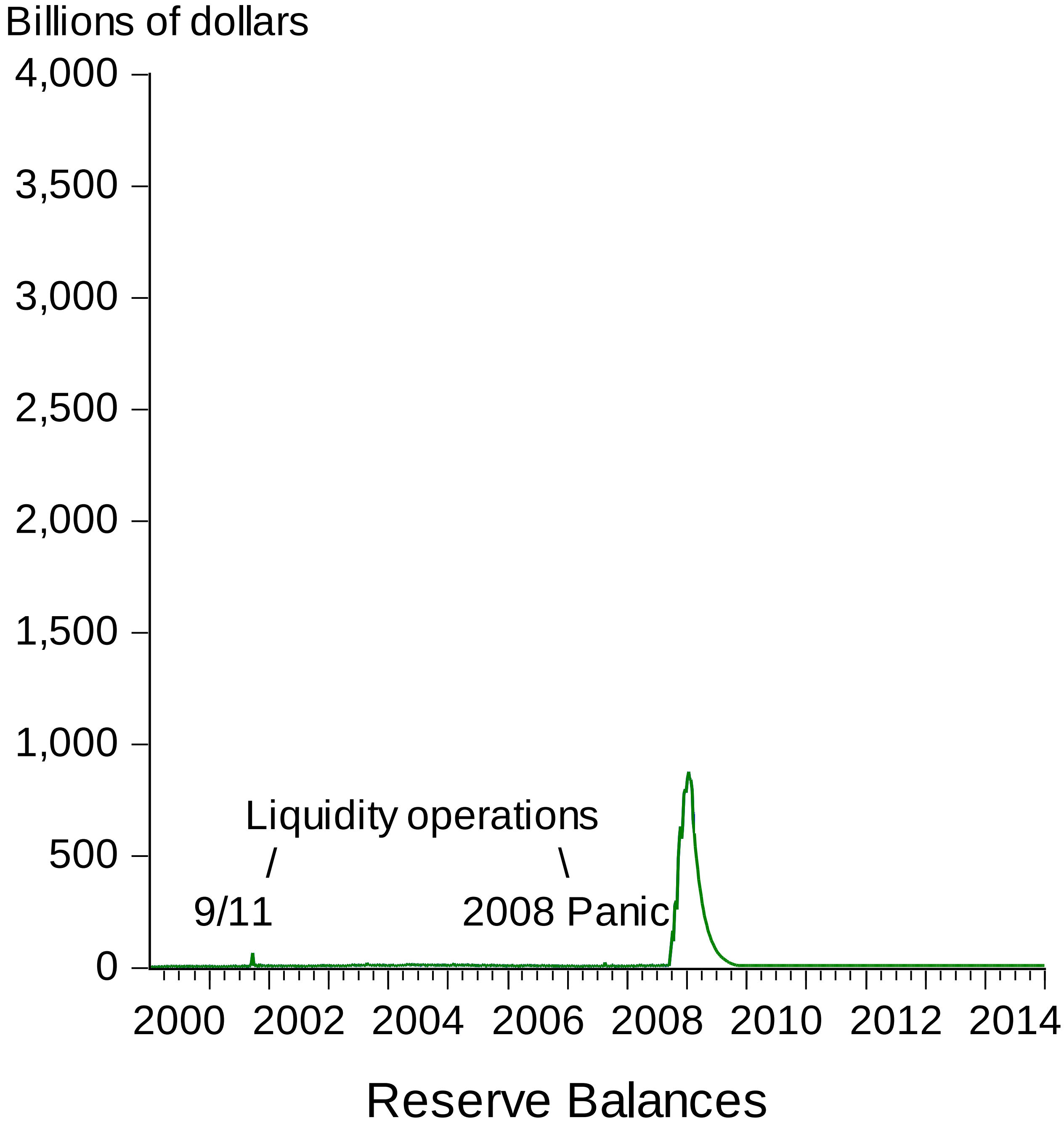
John B. Taylor
Stanford University

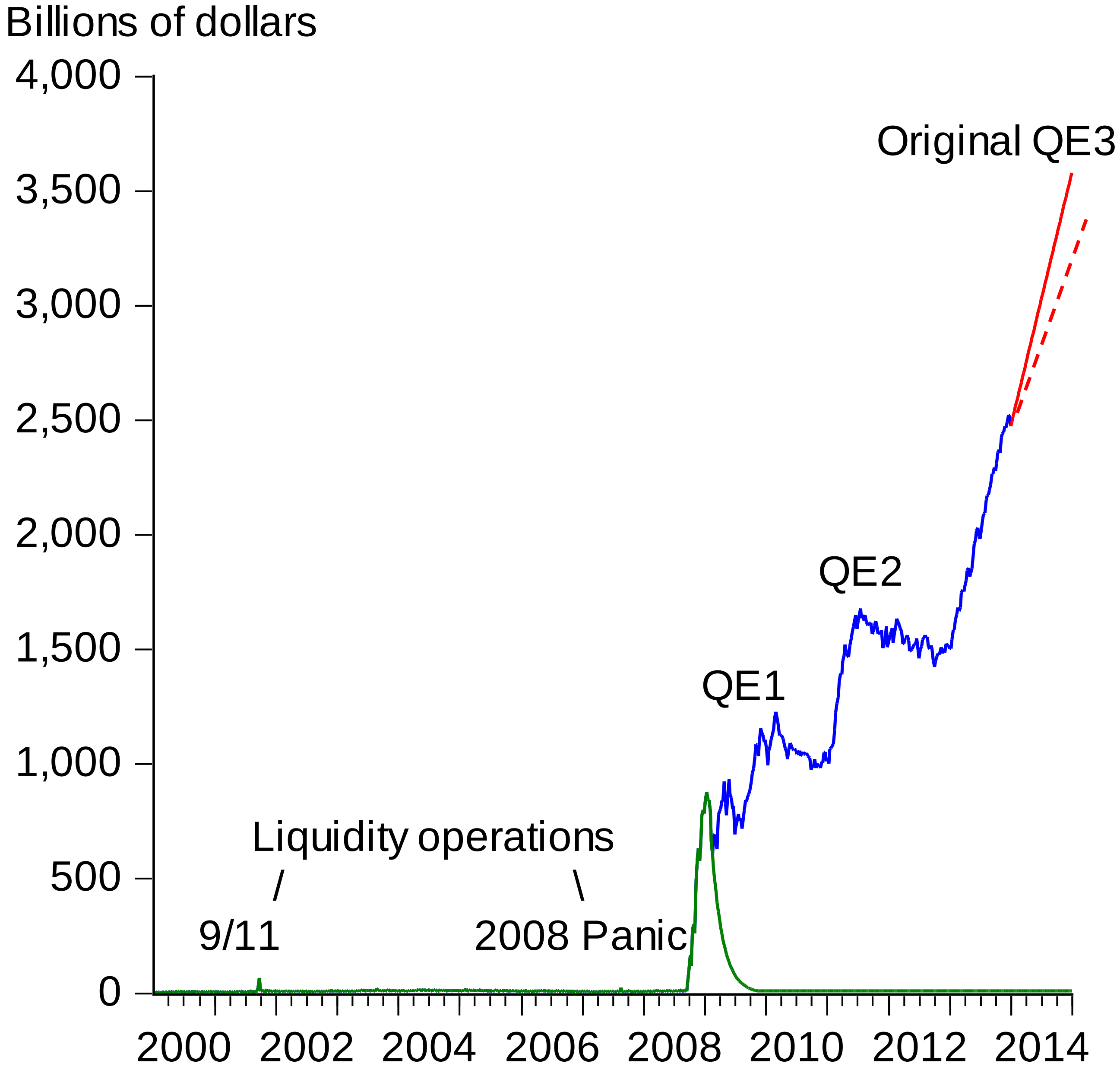
The ECB and its Watchers XV

March 12, 2014

Consequences of Unconventional Monetary Policy

- Many aspects:
  - Unprecedented balance sheet expansion, quantitative or credit easing, prolonged low policy rate, deviating from rule-like policy
- Consider some empirical research, but
  - “The specific measures adopted by the ECB were different in nature insofar as they were aimed at supporting the transmission mechanism by stabilizing the banking system.” (Issing, 2013)


Billions of dollars
4,000
3,500
3,000
2,500
2,000
1,500
1,000
500
0
Liquidity operations
/
\
9/11
2008 Panic
2000
2002
2004
2006
2008
2010
2012
2014
Reserve Balances



Reserve Balances

Empirical evaluation of UMP

- Most favorable evidence comes from announcement effects
  - But these miss the reversal period
- Stroebel-Taylor (2009) found little effect of QE1 MBS once credit and prepayment risks were taken into account
- QE3: When started 10-year Treasury was 1.7%, now 2.7%
- Effects on yield spreads
  - 1-year vs 10-year US Treasury spread
  - 2003-2008 1.3%.
  - 2009-2013 2.4%

Unintended consequences more difficult to quantify

- Distorts price discovery in markets: price controls.
  - With forward guidance, long-term rate doesn’t adjust to events as in normal times.
  - Money markets do not function normally
- Peter Fisher: "[A]s they approach zero, lower rates . . . run the significant risk of perversely discouraging the lending and investment….“
- Uncertainty about unwinding creates 2-sided risk
- Asset purchases create swings in money growth
- Central banks tend to follow others‘ policies creating international impacts that feed back

Adverse effects of low interest rates

- Creates incentives for otherwise risk-averse investors—retirees, pension funds—to take on too much risk
- Undermines of fiscal discipline.
- Excursion into fiscal policy and credit allocation raises questions about central bank independence
- Redistributive in an arbitrary way
- Makes it possible for banks to roll over rather than write off bad loans, locks up unproductive assets.

In practice, forward guidance has been unpredictable

- Federal reserve
  - Dec 2008: "Exceptionally low levels…for "some time…"
  - Mar 2009: "…for an extended period…"
  - Aug 2011: "…at least through mid-2013…"
  - Jan 2012: "…late 2014…"
  - Sep 2012: "…through mid-2015…"
  - Dec 2012: "…at least as long as the unemployment rate remains above 6 ½ percent…"
  - In general forward guidance seems different from what would be appropriate when future comes
- But ECB forward guidance seems meant to be consistent with "reaction function" or "policy rule"

So Need an Exit strategy

- First, clarify where policy is going:
  – Rules-based: learn from what worked and didn't work
  – Deviations from rule; explained by central bank.
- Example: ECB could chose its rules-based policy

  2% inflation target

  2% real policy interest rate--4% nominal (average)

  Greater-than-one principle reaction to inflation (say 1.5)

  Positive reaction to a GDP gap (say .5)

  Inflation = 0.8%, gap(IMF, OECD, EC)=-3.2%, policy rate = .6%

  Inflation = 1.4%, gap (CBO) =-3.8%, policy rate = 1.2%
- When rate goes below zero, look at money growth
- Forward guidance would then be policy rule