Monetary policy in a disinflationary world

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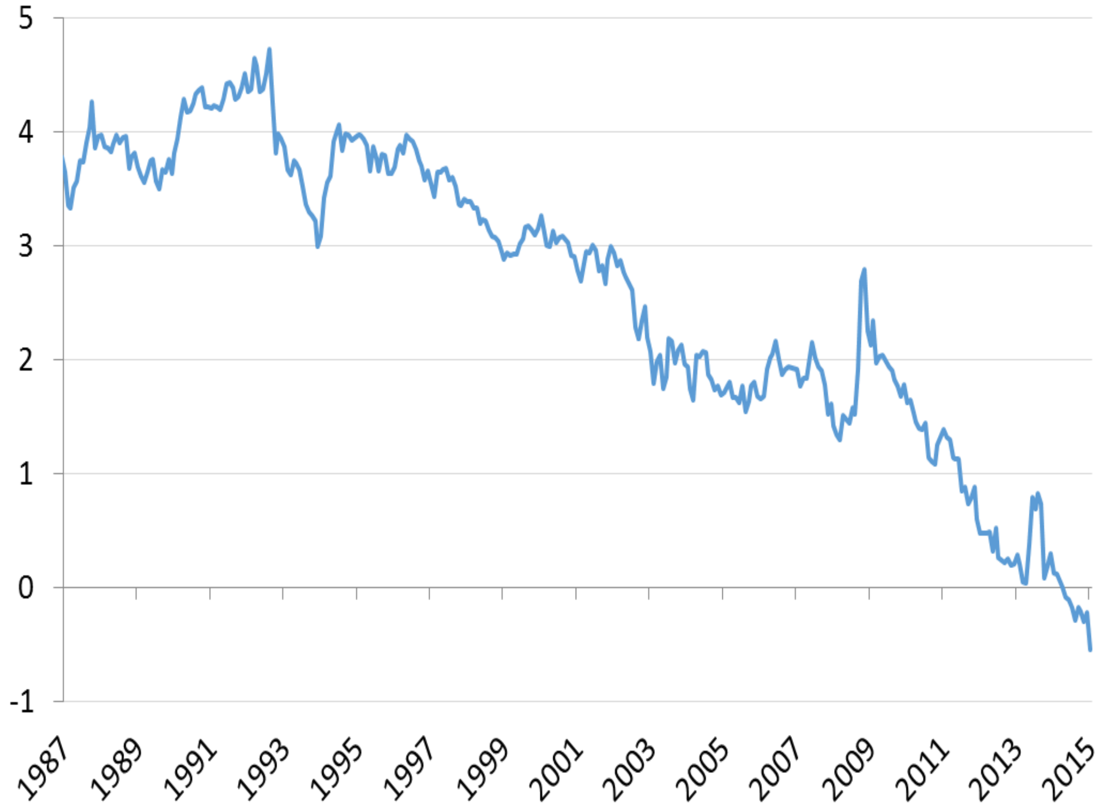
Natural real (safe) interest rate is abnormally low

- Possible causes:
  - Savings glut (demographics, rising inequality, crisis effects…)
  - Investment strike (demographics, slower TFP growth (?), shifting capital intensity, crisis effects…)
  - Portfolio shift to safe assets (EME reserve accumulation, heightened ‘disaster’ risk, QE, bank re-regulation…)

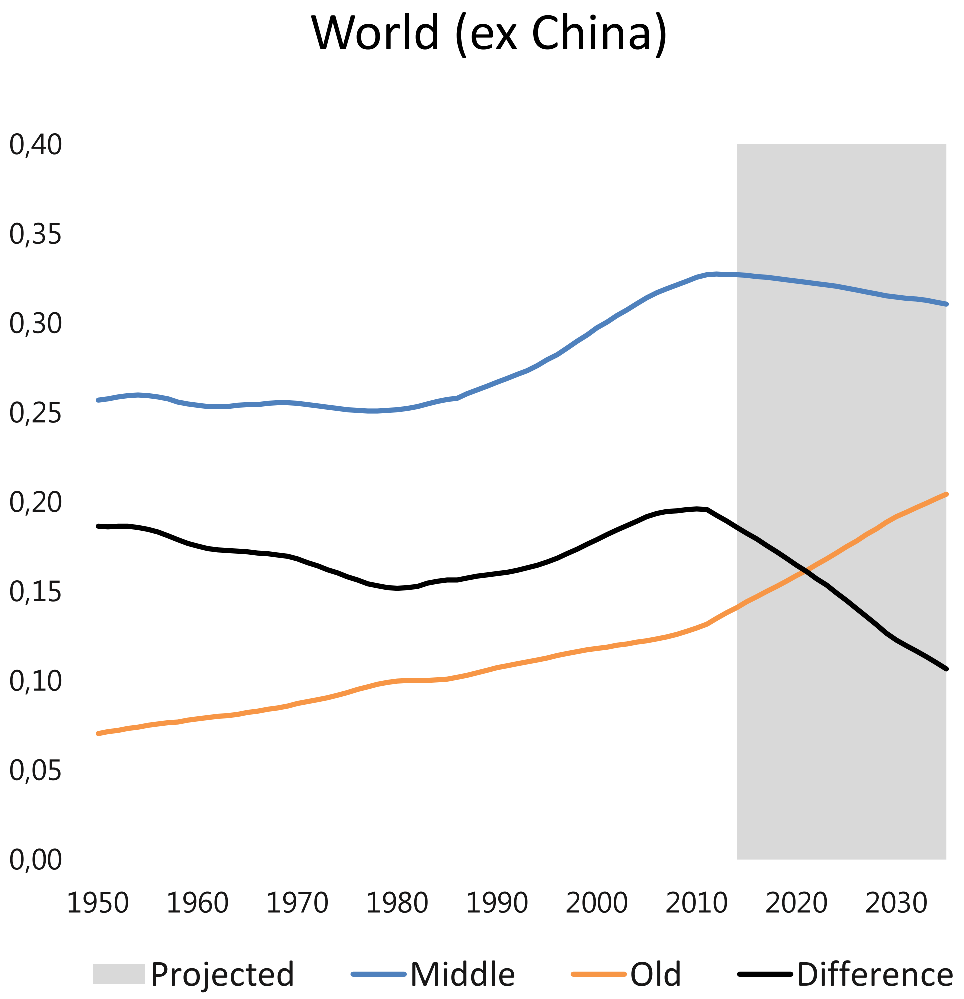
“World” 10-year risk-free real interest rate

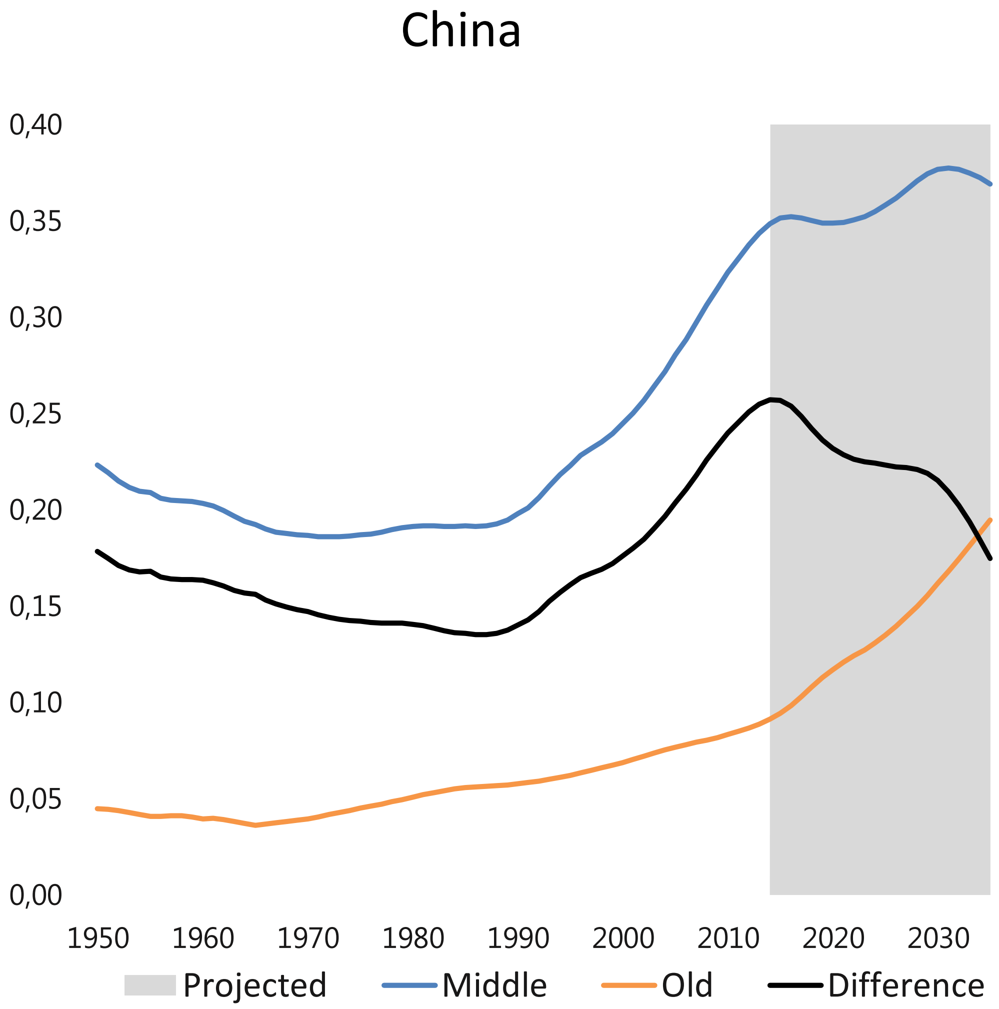


Prospects for natural real rate

- Reasons to expect some rise in natural real rate
  - Demographics have just turned round
  - Dwindling headwinds from financial crisis
- …But yield curve very flat and distribution of short rates truncated on down side → market puts low weight on rise
- So may have low natural real rate for some time yet
- Other things equal, means lower bound (LB) on policy rates bites more often (>15% of time at ½% v 5% of time at 2½%)

Past and projected population shares





Source: United Nations.

Responses: Forward Guidance

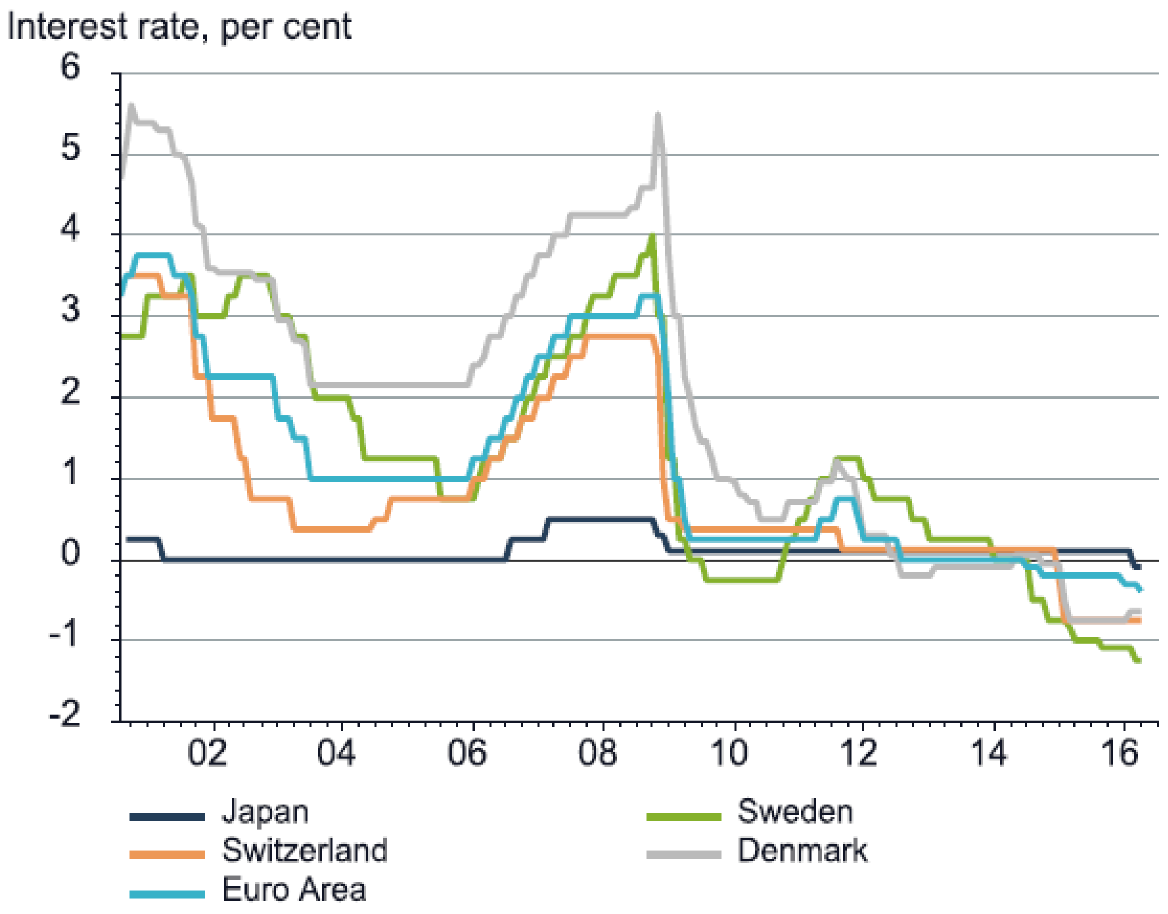
- Keep policy rate “lower for longer” (time-inconsistent path)
  - Incredible as policy makers can’t commit their successors
  - Price-level/nominal GDP target just re-locates the problem
- Actual forward guidance really about better communication
- BoE experience in 2013-4 mixed
  - State-dependent policy (rates held at 0.5% until unemp. < 7%)
  - Guidance appropriate given key uncertainty related to productivity
  - …But interpreted as time-related and productivity forecast poor
  - Arguably damaged MPC’s credibility
- May be worth doing but only relevant at short end of curve

Responses: Quantitative Easing

- Event studies suggest QE1 reduced US & UK yields by ≈ 1pp
- But…:
  - Less effective with normally functioning markets & flat yield curve
  - Significant distributional consequences
  - Purchases of public debt takes central bank into political territory
  - Purchase of private assets takes central bank into political territory
  - Effect on exchange rates/capital flows creates international tension
  - Heightened financial stability risks (encourages search for yield, etc)
- Risk-return trade-off gets worse the more it is used

Responses: Negative policy rates

- How low is the LB?
  - Technical LB negative
  - BoE work suggests UK banks substitute into cash at -½ to -1%
- But economic LB may be higher
  - BoE stopped at +0.5% because of squeeze on bank profits (demand multiplier? FS risks?)
  - Can attenuate with tiered rates
  - May also have a counter-productive effect of expectations



Responses: More exotic options

- Raise inflation target to e.g. 4%?
  - Loses benefit of “stable prices” heuristic
  - Difficult to achieve when inflation stuck near zero
  - May lead to a rise in inflation risk premium
- More exotic options?
  - Eliminate cash
  - Charge interest on cash (Gesell)
  - Break link between cash and reserves (Eisler)
- Relaxing lower bound also worsens FS risks

Conclusion

- Monetary policy not totally ineffective, but risk-return trade-off becoming progressively less appealing
- Time for other policies (fiscal, structural) to play a bigger role
  - Discourage excessive savings (private and public)
  - Raise public investment
  - Encourage private investment
- Should spend more time thinking how to do this responsibly and less on trying to squeeze more out of monetary policy!