How can we manage the lack of monetary policy space?

Monetary policy conference

Bank Negara Malaysia, 26 September 2019

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The views expressed here are mine and should not be attributed to the BIS

Outline

1. Is there a lack of monetary policy space?

2. Review of the various options
   - Give up on the inflation target
   - Patience
   - Fiscal policy
   - Focus on wages

Outline and preview of my conclusions

1. Is there a lack of monetary policy space?

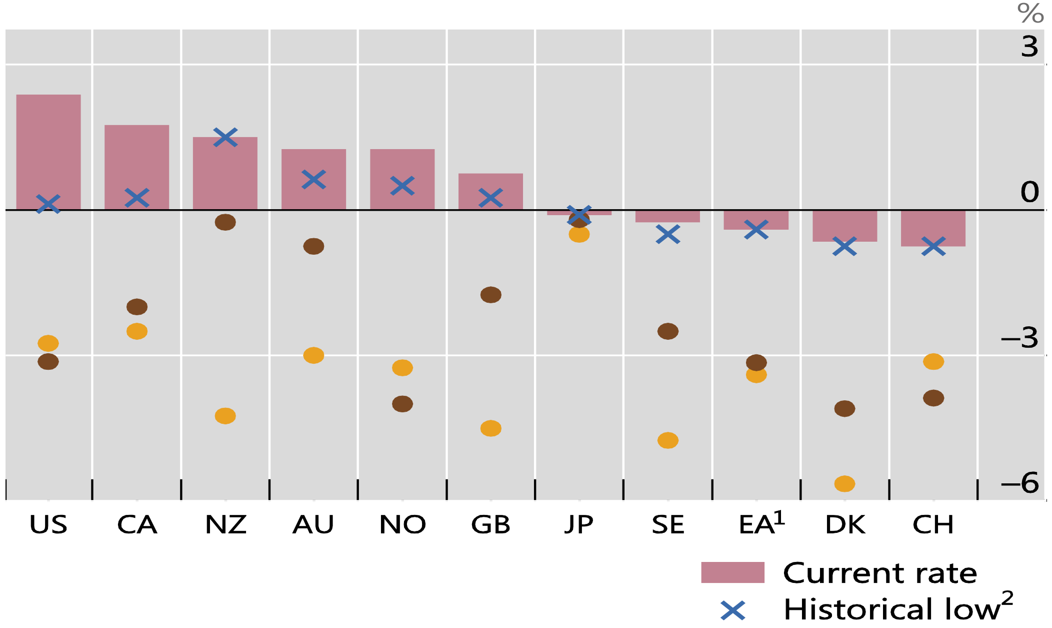
   Space is smaller today, may become critical when the next recession hits

2. Review of the various options
   - Give up on the inflation target, should depend on policy space
   - Patience, OK provided side effects of low rates are contained
   - Fiscal policy, OK provided you have fiscal space
   - Focus on wage inflation, OK provided you are credible

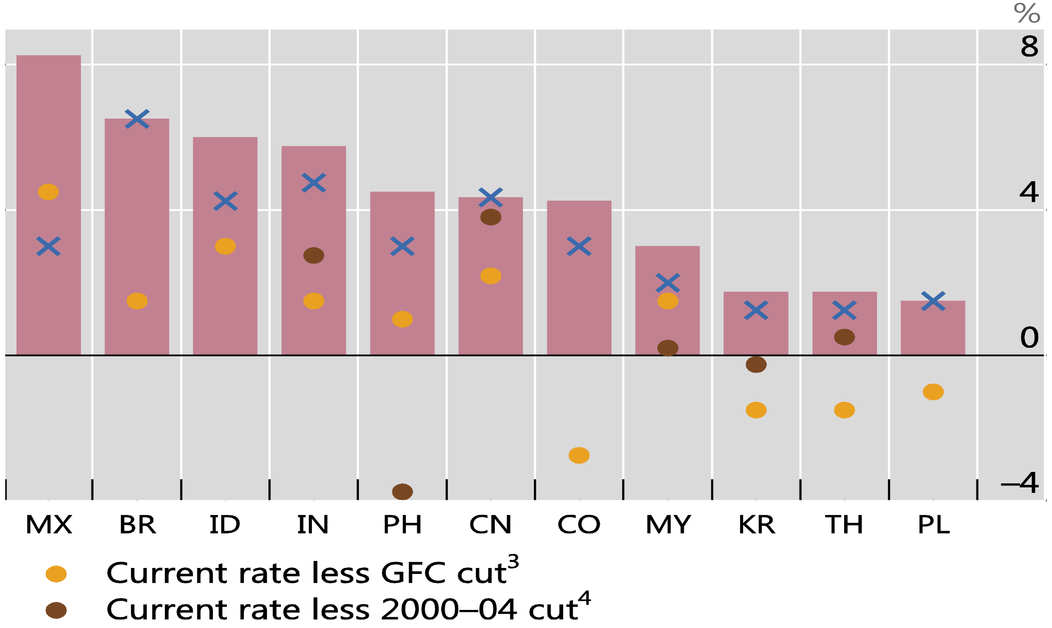
1. Is there a lack of monetary policy space?

The ELB could constrain interest rates especially in AEs

Policy rates, AEs



Policy rates, EMEs

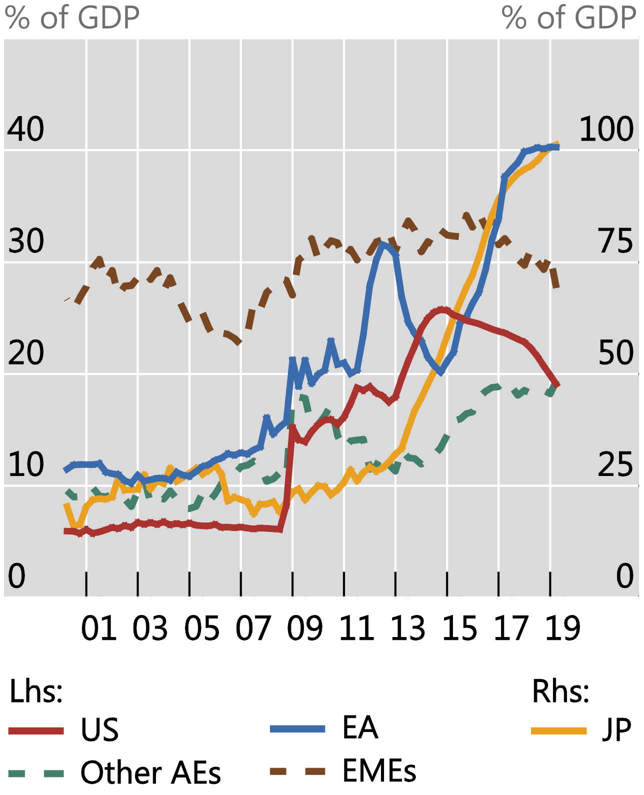


[1] Deposit facility rate as policy rate. [2] Since 1980, or shorter period depending on data availability. [3] Peak-to-trough cut in policy rates within April 2007–June 2010. [4] Excluding BR, CO, ID, MX and PL.

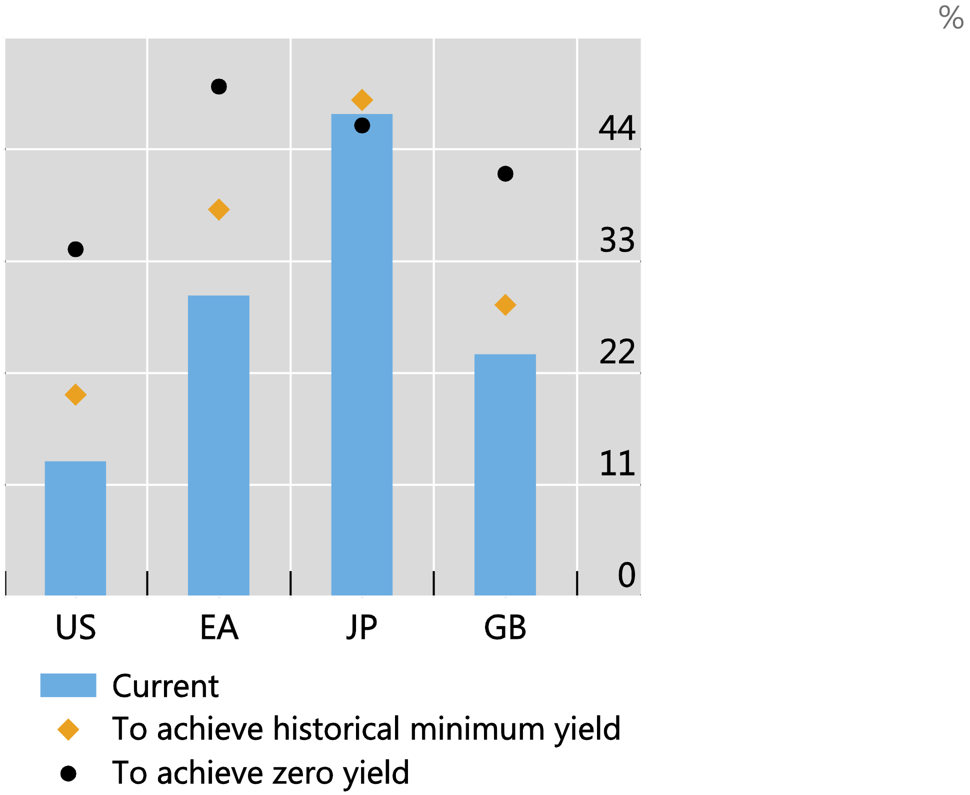
Sources: National data; BIS policy rate statistics; BIS calculations.

1. Is there a lack of monetary policy space?

Central bank balance sheets[1]

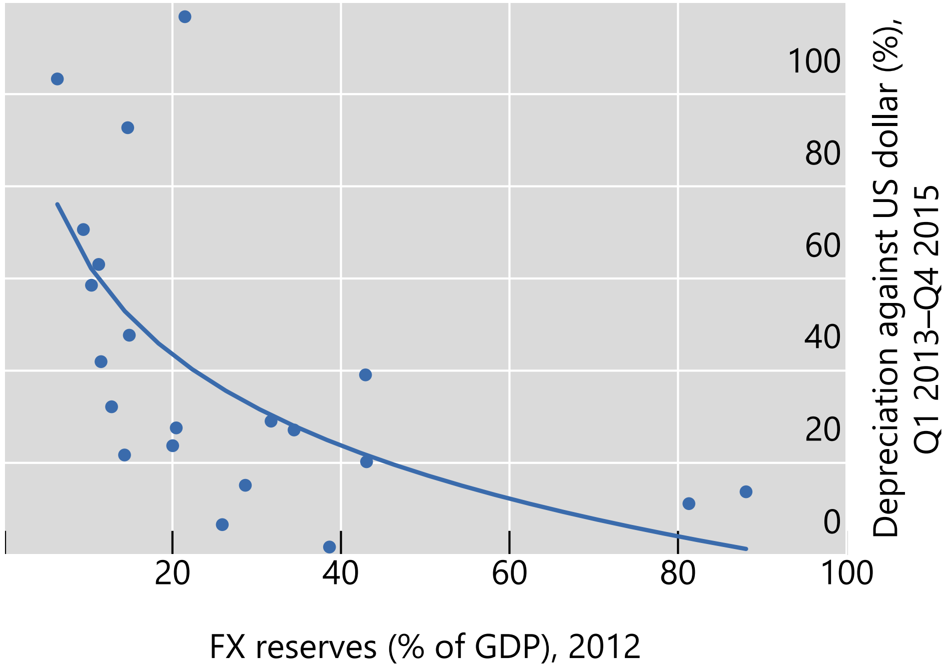


Share of government bonds held by central banks[2]

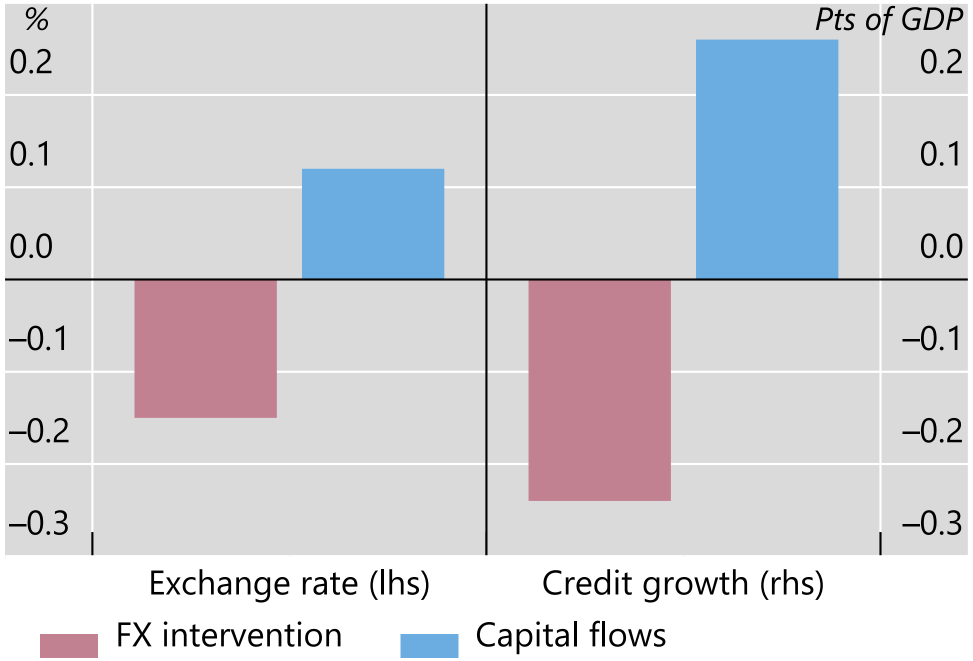


EME other MP tools remain effective: FX intervention enhances resilience

FX reserves cushion the impact of major shocks



FX intervention effects



- Leaning against capital flows “insulate the economy”
- Accumulated reserves provide a cushion

Source: 2019 Annual Economic Report of the BIS chapter 2.

1. Is there a lack of monetary policy space?

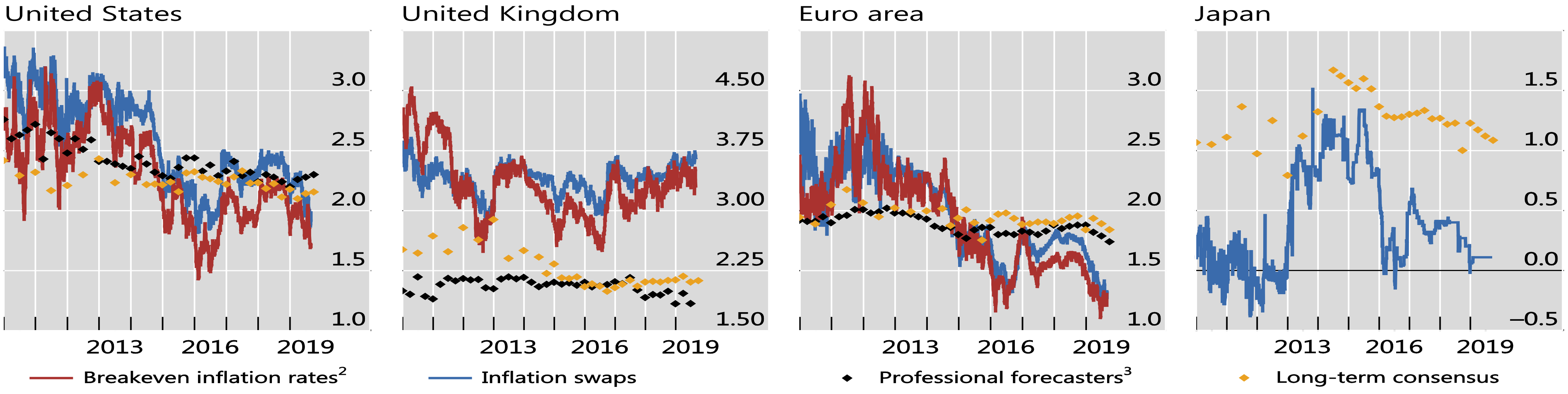
- Cutting down short rates and purchasing assets to cut long rates can go only so far
- The lack of "interest rate" space is very critical in several advanced economies
- And less critical in most EMEs where rates remain higher and tools against typical disinflationary shocks work
  - Leaning against capital flows work
  - \+ it helps limit the risks that exchange rates are destabilising

Alternative option 1: Give up the inflation target

- Main arguments
  - "1.5 or 1.0 % inflation is not harming anyone"
  - It may reflect higher potential growth (a positive supply shock)
  - It may be "global" forces out of control of domestic authorities
- Main risk

Disanchoring of (long-term) inflation expectations

In per cent



Alternative option 2: Patience

- Main argument
  - Temporary yet persistent factors are keeping inflation below target
  - Increase in labour supply keep wages low
    - Demography : ageing of the work force raises the participation of “above 55”
    - This also lowers U* so that there is more slack than the decline in U suggests
  - Globalisation and technology slow the transmission from demand to inflation
    - “Phillips curve” remains only in “domestic sectors”
    - Automation flattens the “Phillips curve”
    - Fat margins help firms absorb increases in costs
- Main risks
  - Dis-anchoring of inflation expectations
  - The “Phillips curve” may be broken for good

Alternative option 3: Fiscal policy

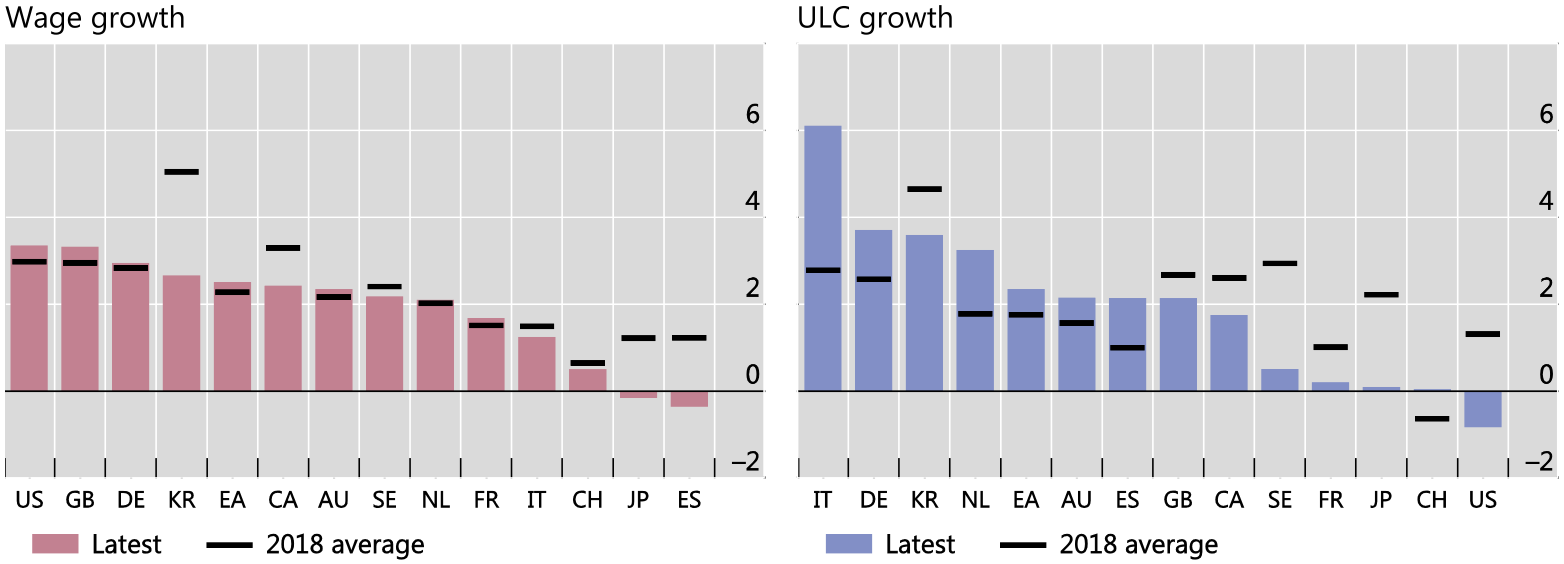
- Main argument
  - Lack of interest rate space
  - Low rates increase the level of sustainable debt
  - Low rates incentivise locking in infrastructure spending
  - Larger public debts would lift interest rates

- Main risks
  - Fiscal policy could end up pro-cyclical
  - The wrong countries act
    - The ones with fiscal space don't use it
    - The ones without fiscal space undermine debt sustainability
  - Resources may be wasted on "transfers"

Alternative option 4: focus on wages

Wage and unit labour cost (ULC) growth in selected economies[1]

Year-on-year changes, in per cent



[1] Latest observations are for Q1 2019, except for US, JP and IT for wage growth and SE for ULC growth (Q2 2019). Definitions differ across countries, in some cases with breaks in the series.

Sources: OECD, *Main Economic Indicators*; Datastream; national data; BIS calculations.

- US and German wages grow well above inflation, however US ULC do not
- Inflation at 2% require wages to grow by "productivity growth + 2%"

Alternative option 4: focus on wages

- Main argument
  - "go direct to wage setting" instead of stretching interest rates and asset prices
  - In the 1980's central banks influenced wage bargaining processes to bring inflation down

- Main risks
  - Lack of credible threats?
  - Has not worked in Japan nor in Germany
  - Again risks of the wrong countries acting
  - Snap back risks on long rates once inflation picks up

Conclusions

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   Space is smaller today, may become critical when the next recession hits

2. Review of the various options
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