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Monetary policy normalization: scenarios and risks

Introduction

Monetary policy in the euro area is at an important turning point. In the face of a series of shocks to the financial system, followed by two recessions, followed by a prolonged period of low inflation – adding up to ten years of economic and financial stress – the Eurosystem has implemented a series of non-standard and in fact in many respects unprecedented measures.

Central bank balance sheets

January 2007 = 100

Source: Thomson Reuters.

1 I thank Mr. Clemens Jobst, Oesterreichische Nationalbank, for his help in preparing this lecture.
As a result, the balance sheet of the Eurosystem increased by a factor of four between the end of 2007 and March 2018 (as shown on slide 1), but size alone does not reflect the full picture of the efforts undertaken. In terms of sequencing, we can distinguish several phases. Notably visible are the several asset purchase programmes, including the securities markets programme (SMP) during the sovereign debt crisis of 2010 and 2011, the purchase of covered bonds and of course the asset purchase programme (APP) running since late 2014. What is also visible in the balance sheet is the generous provision of liquidity to the banking sector through secured lending, both in the early phases of the financial crisis in 2008 and 2009 and more recently through special very long-term operations targeted at supporting bank lending to the real economy. At the same time, however, the Eurosystem also lowered interest rates to levels never seen before, and in fact to levels lower than any observed in most other important jurisdictions, notably the US, UK and Japan. While the main refinancing rate of the Eurosystem is at zero, high surplus liquidity has de facto turned the deposit facility rate into the main policy rate that determines short-term interest rates in the market. The deposit facility rate has been in negative territory for almost four years now. So have been a broad set of short-term market rates up to a maturity of one year. Last but not least, the Eurosystem has striven to calm stress in bank refinancing and financial markets more broadly by committing to unlimited access to liquidity through its fixed-rate full allotment procedure and the announcement of outright monetary transactions (OMT), which by its mere presence contributed significantly to limit tensions within the euro area and encourage lending to the economy.

Now a broad-based economic expansion has taken hold across the euro area. Growth of real GDP has increased to 2.5% in 2017 and is – according to the most recent ECB staff macroeconomic projections – expected to reach 2.4% in 2018, attaining a speed not seen since 2010, followed by 1.9% in 2019 and 1.7% in 2020. Unemployment, while still too high, has declined to 8.7% in the last quarter of 2017 and is thus close to the level last seen in 2009. Inflation has picked up recently and is expected to reach 1.4% in 2018 and 2019 before increasing further to 1.7% in 2020 (again according to the latest Eurosystem projections). This improvement in the economic environment is to a significant extent due to the expansionary policies of the Eurosystem. Today, the monetary policy of the Eurosystem continues to be very expansionary. Interest rates are still negative, the asset purchase programme is still running, and we have committed to keep rates low well beyond an eventual phasing-out of further asset
purchases. The broad-based improvement in the economic environment, however, gives us the opportunity to take a step back from non-standard monetary policies and start thinking about normalization.

**Development of GDP and inflation since the beginning of the big recession**

Normalizing monetary policy

Normalization has two aspects. First, it refers to the process of unwinding the non-standard measures we have implemented over the past ten years, the sequencing of the process, and its specific timing. At the same time, normalization also evokes the question of what the end point of such a process could be, i.e. what constitutes the normal state of monetary policy – in contrast to non-standard or unconventional monetary policy.

The answers to both questions are far from straightforward. The length of the period that non-standard monetary policy measures have been in place and the significant changes that we have seen in the functioning of our economies, the financial system and the regulatory environment, have led a number of observers to argue that monetary policy cannot simply return to pre-crisis mode. According to this argument the so called “new normal” will be different from the “old normal”. Let me next discuss the process of normalization before I return to the possible
features of the “new normal” and potential consequences for monetary policy in the second part of my lecture.

The process of normalization

Independently of the precise end-point, the process of normalization itself brings with it already a number of challenges. Tightening monetary policy has never been easy. This time, the exceptional scale of monetary policy intervention, the number of instruments employed and their potential interactions render the tightening process even more complex and delicate than usual.

When tightening monetary policy, central banks face two types of risk: the risk of tightening too early and the risk of tightening too late. When tightening too early, central banks run the risk of stifling an incipient pick-up in the real economy and pushing inflation below target. When tightening too late, on the other hand, the most likely immediate effect is the encouragement of booms in asset markets, which might build up before the consequences of an overly accommodative policy feeds through to headline inflation.

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<th>Policy and market interest rates</th>
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<td>1999</td>
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<td>ECB main refinancing rate</td>
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<td>Fed target rate</td>
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Source: Macrobond.
Previous experiences with ending periods with exceptionally accommodative monetary policy suggest that balancing these risks is not straightforward. The historic case that comes closest to the current situation in terms of the low level of interest rates is the early 2000s both in the US but also the euro area. In the early 2000s the economic situation in the US was marked by the end of the dot-com boom in early 2001, geopolitical uncertainties associated with the terrorist attacks of September 11 and the invasion of Iraq in 2003 as well as by a series of corporate scandals. In reaction, the Federal Reserve lowered policy rates from 6.5% in late 2000 to 1.75% in 2001. The Fed funds rate reached what was then the historic low of 1% in June 2003.

Several economists have criticized the Fed for having lowered rates by too much and for having kept them too low for too long. The standard tool to assess the relative stance of monetary policy is to compare actual rates with rates calculated on the basis of a policy rule, such as the Taylor rule, which links the policy rate to deviations of inflation from the inflation target and the output gap (Taylor, 1993). For the US during the 2000s, Taylor himself has argued that policy was relatively loose compared to previous behaviour of the Federal Reserve. As a result, the real interest rate turned negative for a very long period, similarly to what happened in the 1970s, which, according to Taylor, added fuel to the housing boom and contributed to the severe crisis that the US (and the world economy) entered into in 2008 (Taylor, 2011).

But analyses based on the Taylor rule are sensitive to the relative weights given to inflation and the output gap and the particular way the two variables are measured. Add to that the difficulty of observing the output gap in real time. Based on a different choice of inflation measures and taking into account what type of information was available to policy makers at the time, Bernanke (2010) concludes that policy was not exceptionally accommodative in the early 2000s. The start of the housing boom, on the other hand, well predated the period of low interest rates, and the subsequent build-up of risks was due to imprudent lending standards and financial innovation rather than to monetary policy.

While emphasizing different aspects of the run-up to the Great Financial Crisis, both views are not necessarily contradictory but point toward a number of lessons which might be useful at the current juncture as well.

First, as a comparison of different estimates for Taylor rates illustrates, the assessment of monetary policy depends very much on the choice of the measure for inflation and slack in the
A key issue here is how to deal with the wide swings in global commodity prices. The conventional wisdom in monetary policy (see e.g. Mishkin, 2007) is that policy makers should “look through” such cost-push shocks, as long as inflation expectations remain anchored. One way of doing so is to use core inflation instead of headline inflation measures. The bad news, however, is that there is no single measure capturing the underlying rate of inflation. Comparing different sub-indices of the HICP, the ECB (2013) concludes that none of them satisfies the criteria for an unbiased underlying-inflation measure for the euro area. Moreover, items that might have been highly volatile in the past may not be so in the future. Hence, any core measure will itself likely be subject to transitory shocks. Consequently, most central banks – like the Bank of Japan, the Bank of Canada, the Bank of England, the Swedish Riksbank, the Reserve Bank of Australia, the European Central Bank, to name but a few – continue to focus on headline inflation. Nevertheless the discussion reminds us of the need of a broad-based assessment of economic indicators.

A second lesson concerns the interaction of monetary policy with financial markets. The housing boom in the US as well as the risk-taking and mispricing of risk that went along with it is certainly due to a larger number of factors than monetary policy alone. But it is not necessary that monetary policy causes financial cycles, it is already enough when a relatively loose monetary policy reinforces a financial cycle already present before.

What is the new normal?

While the pre-2008 mainstream view of monetary policy, namely that low and stable inflation should be the primary objective of monetary policy, survived the Great Financial Crisis largely intact (see e.g. Reichlin and Baldwin, 2013), several observers argue that the functioning of our economies has changed and that monetary policy should be adapted accordingly. One frequently mentioned change concerns the apparent decline in long-run real interest rates over the last decades (IMF, 2014). Another observation is the increasingly weak relationship between domestic economic slack and inflation (known as the Phillips curve). This means that one important transmission channel for monetary policy, namely to influence price developments by creating or reducing economic slack in the real economy, works less efficiently than it has done in the past. Recently, some economists spoke of a “twin puzzle” after the Great Financial Crisis: first, a “missing disinflation” between 2009 and 2011, when economic slack was considerable yet
inflation rather strong (Coibion and Gorodnichenko, 2015), followed by a “missing inflation” after 2012, particularly in Europe (Constâncio, 2015). As slide 4 illustrates, core inflation has fluctuated slightly below 1% since 2014, and has yet to show more convincing signs of a sustained increase. The phenomenon is not restricted to the euro area. Inflation in the US today, once corrected for imputed housing costs and thereby made comparable to our HICP measure, is actually lower than in the euro area, even though the economic and monetary policy cycles in the US are several years ahead compared to the euro area.

**HICP inflation and core inflation in the Euro area**

Economists have identified several factors that can explain why the Phillips curve has become flatter. The question had already attracted interest before the financial crisis. Bernanke (2007), for example, has attributed the lower responsiveness of wage and inflation to the domestic cycle to the credibility that central banks had built up over the preceding decades. According to this argument, if expectations are well anchored, actual inflation will be mostly driven by expectations, not domestic slack. Recent difficulties of central banks in driving up inflation to their desired level, however, show that the credibility argument cannot account for the full story.
An alternative line of arguments points to the globalisation of product, labour and capital markets. As Freeman (2007) points out China, India, and the ex-Soviet bloc joined the global economy all at once in the 1990s. As a result, the size of the global labour pool approximately doubled. At the same time, a new geopolitical situation and technological advances (e.g. outsourcing, offshoring, substitution of capital for labour) created an environment in which workers were not just competing with fellow workers in the same country, but also with those abroad. Consequently, the bargaining power of labour decreased, in turn weakening the relationship between price developments and the domestic cycle. Similar arguments can be made for global product markets. Auer et al. (2017) for example argue that the expansion in cross-border trade in intermediate goods and services (the so-called expansion of global value chains) intensified global interconnectedness.

As a result, domestic inflation became less and less dependent on domestic slack and unemployment, while becoming increasingly determined by a global output gap. Inflationary and disinflationary factors are increasingly global in nature and largely outside the realm of
individual central banks. They have altered domestic inflation processes and complicated the lives of central bankers around the world, as monetary policy requires increasingly large output gaps to steer inflation. As Constâncio (2015) remarked, “a flatter slope of the Phillips curve would make controlling inflation either more costly or more difficult”. At the same time, aggressive monetary policy runs the risk of endangering financial stability. Borio (2017) draws the conclusion that monetary policy should lengthen the horizon over which to bring back inflation towards its target level.

Faced with these evolutions, some economists have argued for adjusting inflation-targeting frameworks by e.g. lowering the inflation target or switching from point targets to explicit target ranges that would allow for prolonged periods of lower or higher inflation within the target range.

In my view, the framework of the ECB is already well equipped to deal with the evolving economic setting. The inflation objective of the ECB has from its beginnings been focused on the medium term. The medium term has always been defined as a flexible concept, taking account of lags in monetary policy transmission and the fact that inflation is driven not only by monetary policy but by supply-side and demand-side factors outside monetary policy as well. Central banks cannot fine-tune inflation, and they should not be expected to do so. If changes in the functioning of the economy mean that lags in monetary policy transmission get longer, then our understanding of the medium term has to be adjusted accordingly. At the same time, the lag in monetary policy implementation means that the side-effects on financial stability are more likely to materialize and should be monitored closely. As I argued before, the two-pillar strategy of the ECB, which incorporates a broad range of real economic and financial indicators, is a good fit for such an approach.

**Monetary policy in the new normal**

What are the conclusions that we can draw from this assessment for our current policy stance? First of all, it is a call for patience. Given the possible structural changes in the inflation process and global factors that temporarily exercise a downward pressure on inflation, I would argue that current inflation rates, even though they fall somewhat short of our medium-term objective, do not constitute a threat to price stability. Current inflation rates continue to reflect
the particular severity of the shocks encountered by the euro area in the past years and the financial fragmentation that went along with it. The euro area is currently enjoying its fifth consecutive year of GDP growth. Since mid-2014 this growth can also be dubbed “reflationary”, in the sense that quarterly growth readings have consistently outpaced potential growth rates. Against the backdrop of a reflatting economy, the inflation outlook is consistent with our aim of an inflation rate of below, but close to, 2% over the medium term.

Second, it reminds us of the necessity of looking beyond the development of consumer prices and taking a broader range of economic indicators into account, many of which are developing well. A broad approach to economic and monetary analysis has been a key pillar of the ECB framework from the beginning, and shall continue to be so.

Third, it is a call for gradualism. Gradualism means that normalization should not be started too early. But it also means that normalization should not be started too late. The longer market interest rates remain at their current very low or even negative level, the higher the risk of misallocation of credit, mispricing of risk and general distortions in the economic process. But the process of normalization needs to be well-dosed and well communicated to avoid abrupt shifts in expectations, which might threaten the process of economic recovery and the return of inflation towards our medium-term target. This is a further argument why normalization should not be started too late.

At the moment, many of the non-standard policies that the ECB has mobilized over the past decade to support the economy are still in place. Net purchases under the APP are an important but by far not the only element in this policy mix. The ECB has started a first round normalization by lowering the monthly net purchases from 60 billion EUR to 30 billion EUR from January 2018. But even after a possible end to net asset purchases, the ECB’s policy will continue to be very accommodative. Recall that the ECB is the only major central bank operating with negative interest rates and that – in line with our policy of forward guidance – we signal that we expect rates to remain at their present levels for an extended period of time, and well past the horizon of our net asset purchases. Our interest policy thus continues to provide significant monetary stimulus. The same, however, is also true of the APP even after the end of net asset purchases. By September 2018 the volume of assets acquired under the APP will amount to more than two and a half trillion euro. The Eurosystem will continue to reinvest the
principal payments from maturing securities purchased under the asset purchase programme for an extended period of time after the end of its net asset purchases, and in any case for as long as necessary. Thereby the APP will continue to contribute both to favourable liquidity conditions and to an appropriate monetary policy stance.

### Liquidity provision in the euro area

**in EUR billions**

![Graph showing liquidity provision in the euro area](source: ECB, own calculations.)

**Conclusion**

Let me conclude. The euro area economy is in the middle of a strong and broad-based cyclical upswing. Over the past years monetary policy has contributed significantly to the recovery by fending off the risk of deflation, supporting the cohesion of monetary union and ensuring that the monetary stimulus came to operate in all parts of the euro area. Now it is time to think about the gradual normalization of monetary policy. As I argued, normalization is a process that requires a delicate balancing of measures as well as careful sequencing and timing. But normalization is also influenced by what we expect the end-point of the process – the normal – to be. There are many indications that the way our economies operate has evolved over the past
decades. It seems likely that the new normal will be characterized by longer lags in the transmission from monetary policy to inflation. This recognition has also a bearing on the design of the normalization process. There is little doubt that with actual growth exceeding potential and with unemployment falling, inflationary pressures will materialize eventually. At the same time, the longer lags in the transmission from monetary stimulus to inflation mean that policy might become pro-cyclical, increasing the likelihood of financial stability risks building up. We should thus not wait too long to get the next steps of the normalization process started.

Thank you for your attention.
References


