Monetary Policy—Unintended Consequences
On the Way Out

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MIT

Globalisation Dynamics: EU and US perspectives
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A challenge?

- Asynchronized policy cycles among major central banks can be challenging:
  - Capital flows—with or without a global savings glut.
  - Macroprudential concerns.

- Following the successful implementation of prompt and decisive QE, Fed has embarked on policy tightening.

- Should other major central banks follow? Even CBs that, unlike the Fed, did not engage in prompt and decisive QE?

- Is it wise to ignore domestic “lowflation” and continued weakness in real economy to follow the Fed?

- Could an unintended consequence of following the Fed “on the way out” be a classic policy tightening mistake?
Classic tightening mistakes at the ZLB in global CB history

- **Fed:**
  - 1936: doubling of reserve requirements, implied rate hike.

- **BoJ:**
  - 2000: end of ZIRP rate hike.
  - 2006: rate hike and quantitative tightening.

- **ECB:**
  - 2010-11: rate hikes.
  - 2012-14: quantitative tightening (shrinking balance sheet by a third).
Three major CBs at the ZLB: Overnight interest rates

![Graph showing overnight interest rates for the United States, Euro area, and Japan from 2001 to 2017. The interest rates are negative and fluctuate over time, with the United States having generally higher rates compared to the Euro area and Japan.](image)
Three major CBs at the ZLB: Size of Balance Sheet

Index, August 2008 = 100.
Follow the leader on the way out? The ECB challenge

▶ Did the ECB follow the Fed in its prompt and decisive QE?

▶ Has the ECB done enough to fulfill its mandate? Has inflation been restored to 1.9% in a sustained manner?

▶ Has the ECB done enough to restore the health of the real economy in the euro area?

▶ Do the answers to any of these questions matter for assessing whether it is sensible for the ECB to follow the Fed on the way out?
Fed vs ECB: Outlook for headline inflation

### September 2017 projections

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Implications of **not** following the Fed’s prompt and decisive QE.

- “Lowflation” projected to continue well into the future in the euro area.
- Unnecessary harm to real economy in most member states of the euro area.
- Deterioration of debt dynamics—raising odds of failure of euro.
- . . . the price to pay? **More and for longer QE** is now essential in the euro area to compensate for earlier policy mistakes. (Similar to BoJ experience a decade earlier and decisive QE in 2013.)
Notably below and **not** close to 2% for several years.
Long-term inflation expectations in euro area

ECP SPF. Surveys after May 2003 clarification of ECB inflation objective.

An unhelpful disanchoring of inflation expectations.
### Inflation projections since start of ECB QE

<table>
<thead>
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**Why the reluctance to do more?**
Health of the economy: Unemployment rate
Health of the euro area economy: Unemployment rate

Which euro area?
Core inflation in the euro area

Which euro area?