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Central Banking in the XXI century: never say never.

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State of the art (literally)

- Central banking is an art (R.G. Hawtrey, 1932)
- Arts are as much about rules as about revolutions:
  "Learn the rules like a pro, so you can break them like an artist" (Picasso)
- Central bankers learned (Taylor) rules for a long while, but broke them when they looked inadequate.
- They stand ready to do it again if/when necessary.
- **Key lesson: never say never.**

State of the euro area

1. Exceptionally expansionary monetary policies.

2. Low inflation and a fragile recovery.

- The diagnosis is far from obvious:
  - Demographics?
  - Declining productivity?
  - Financial cycle?

- Whatever the explanation, this experience raises questions on the very foundations of MP.

Three essay questions on monetary policy

1. **Objectives**: is it sensible to stick to price stability?

2. **Effectiveness**: are we using the right tools to achieve it?

3. **Side effects**: what is the cost of pursuing a price stability target today?
   - ✓ Risk taking
   - ✓ Inequality

(1) Objectives of MP

The idea of aiming for an inflation rate "below but close to 2%" is under scrutiny:

- Perhaps CBs should focus on longer horizons (Issing, 2016)
- Perhaps low inflation is beneficial if it is caused by supply shocks (Borio, 2015)
- Perhaps there comes a point where the costs of monetary expansion exceed its benefits.

(1) Objectives of MP

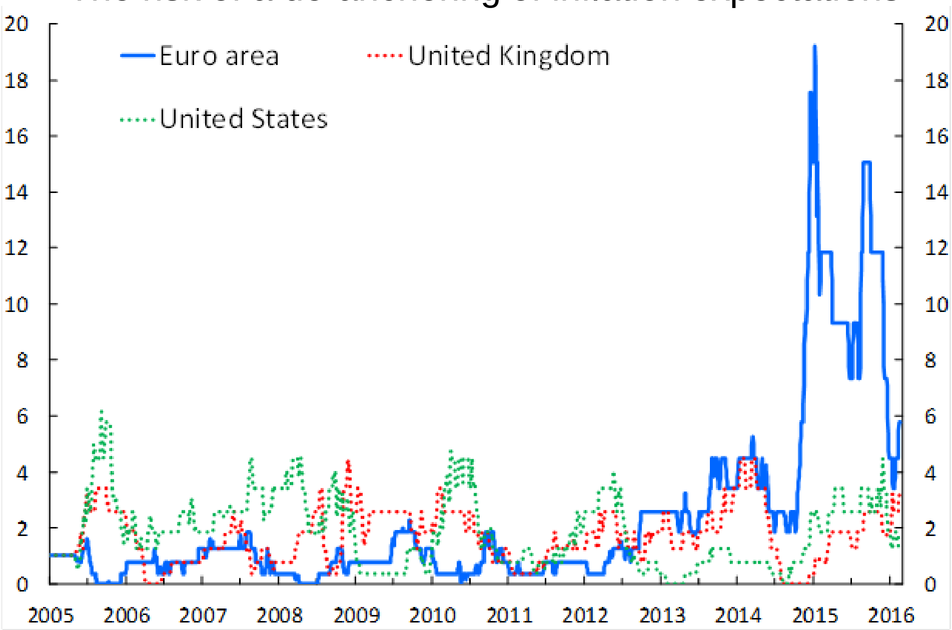
Maybe. However:

- The ZLB limits CBs’ room for action.
- High debt increases the risk of a ‘debt deflation’ spiral.
- Temporary low-flation can escalate into a long-term problem: de-anchoring risk.
- Costs and side effects of MP are elusive (more on this later).

From short to long run: de-anchoring

- The correlation between short and long-term inflation expectations is a proxy of de-anchoring risk.
- In the EA, this correlation has been highly since 2015:

The risk of a de-anchoring of inflation expectations



Source: Natoli and Sigalotti (2015).

- Investors worry about low inflation in the long run.
- This could be a bad time to question the target.

(2) Effectiveness of MP

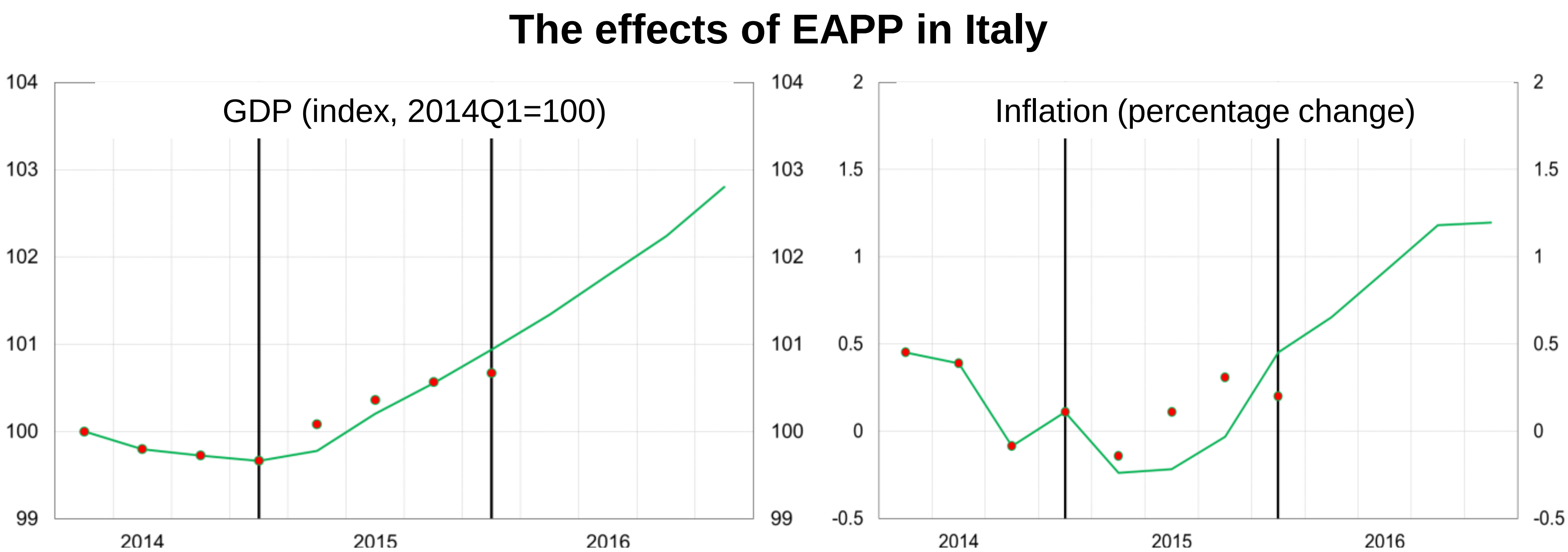
Fine … but is MP working?

- ❑ The ZLB reduces its degrees of freedom
- ❑ The crises have impaired its transmission mechanism
- ❑ In general you cannot "push on a string".

Certainly. However:

- ➢ Interest rates can go negative.
- ➢ CBs can work with quantities as well as prices (EAPP).
- ➢ We must turn to models to answer this question.

Quantifying the impact of EAPP



Data (red) versus model-based projection (green)

- ❑ On a 3-year horizon: GDP +2%, inflation +1%.
- ❑ GDP data is so far consistent with our projections.
- ❑ Inflation is lower (weak global demand, low oil prices).

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What else can be done?

- An effective stabilization typically requires a combination of interventions.

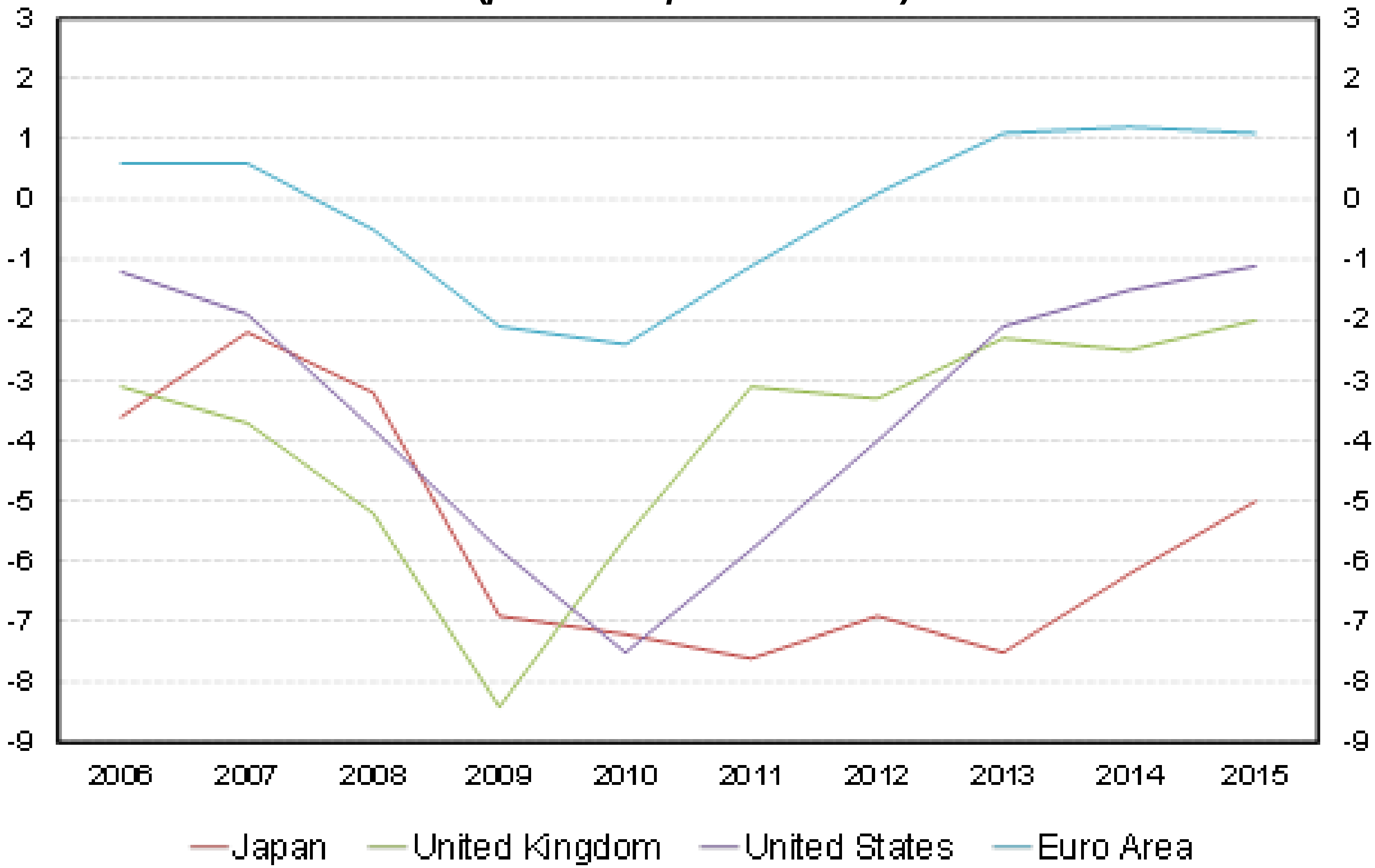
- MP works, but it should not be 'the only game in town'.

- The relatively weak performance of the eurozone might be down to fiscal policy being
  - ***"less available and effective"*** than elsewhere (Draghi, 2014)
  - ***"much tighter than demanded by economic conditions"*** (Bernanke, 2015)

The fiscal stance in the euro area

Cyclically adjusted primary balance in advanced economies

(*percent of potential GDP*)



Source: IMF staff estimates.

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(3) Financial stability consideration

Should financial stability considerations interfere with MP?

- Investors risk more when monetary conditions are loose
- Low rates may chip away at banks’ profitability
- MP is also a financial stability tool (Stein, 2013)

Undisputable. However:

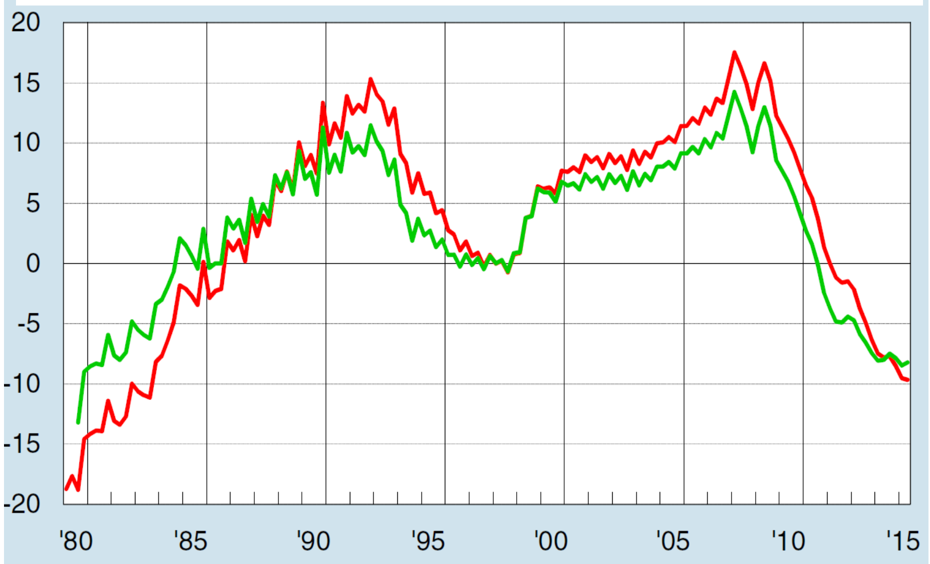
- Price and financial stability are complementary in the medium run: <u>there can be no real safety without growth</u>.
- There are no signs of exuberance in the euro area.

Assessing the financial cycle

- CBs routinely monitor a range of financial indicators …

- The "credit cycle" is (still) in a negative phase.
- We do not have an excessive risk taking problem.

The credit cycle in Italy (Credit-to-GDP ratio, detrended)



Source: Banca d'Italia Financial Stability Report, November 2015

- … but do prudential authorities monitor the macroeconomy?
- Excessive restrictions could slow down the recovery, increasing rather than reducing aggregate risks.

(4) MP and inequality

Does the current MP stance favor the rich?

- Savers are 'expropriated' via low interest rates.
- Capital gains accrue mostly to wealthy households.
- Refinancing and OMOs benefit banks rather than the people.

Inequality lies outside CBs' mandates.
Yet this debate is important for two reasons:

- Social and economic stability go hand in hand.
- CB Independence may be at stake.

What are the distributional effects of MP?

- This is a general equilibrium problem. MP affects:
  - Cash and deposits (–)
  - Bonds and equities (+)
  - House prices (+)
  - Wages and employment (+)

- Bernanke (2015) proposes a simple thought experiment:

  "If the average working person were given the choice of the status quo (current Fed policies) and a situation with both a weaker labor market and lower stock prices (tighter Fed policies), which would he or she choose?"

  Most probably the latter.

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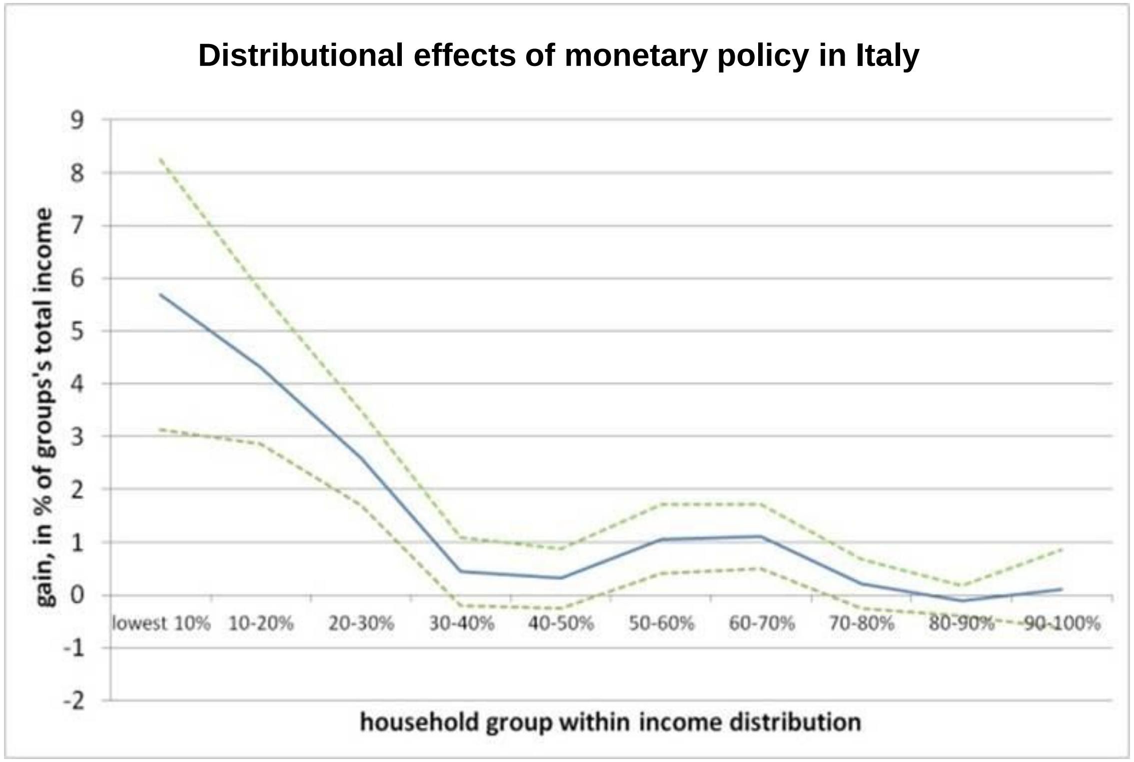
MP and inequality in Italy

The impact of the 2011-2012 ECB interventions:

estimates based on micro data from the Survey of Income and Wealth



Source: Casiraghi et al. (2016b)

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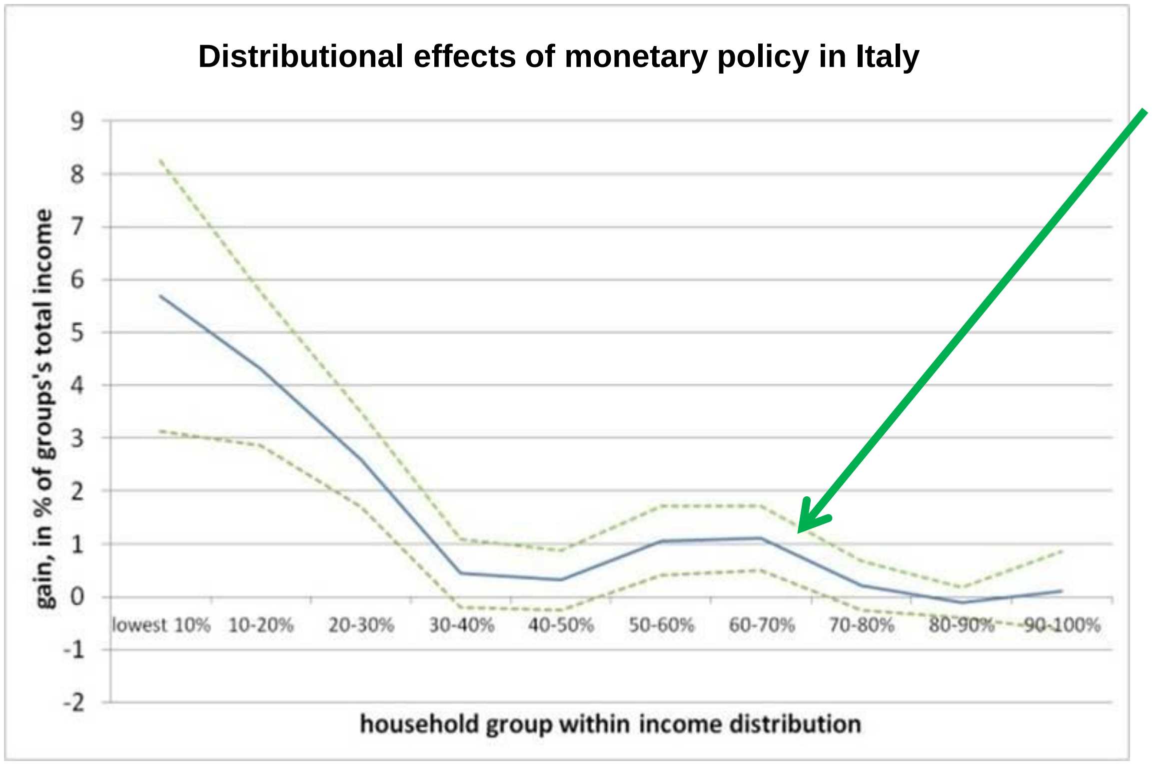

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1. The rich benefited from <u>financial gains</u>.

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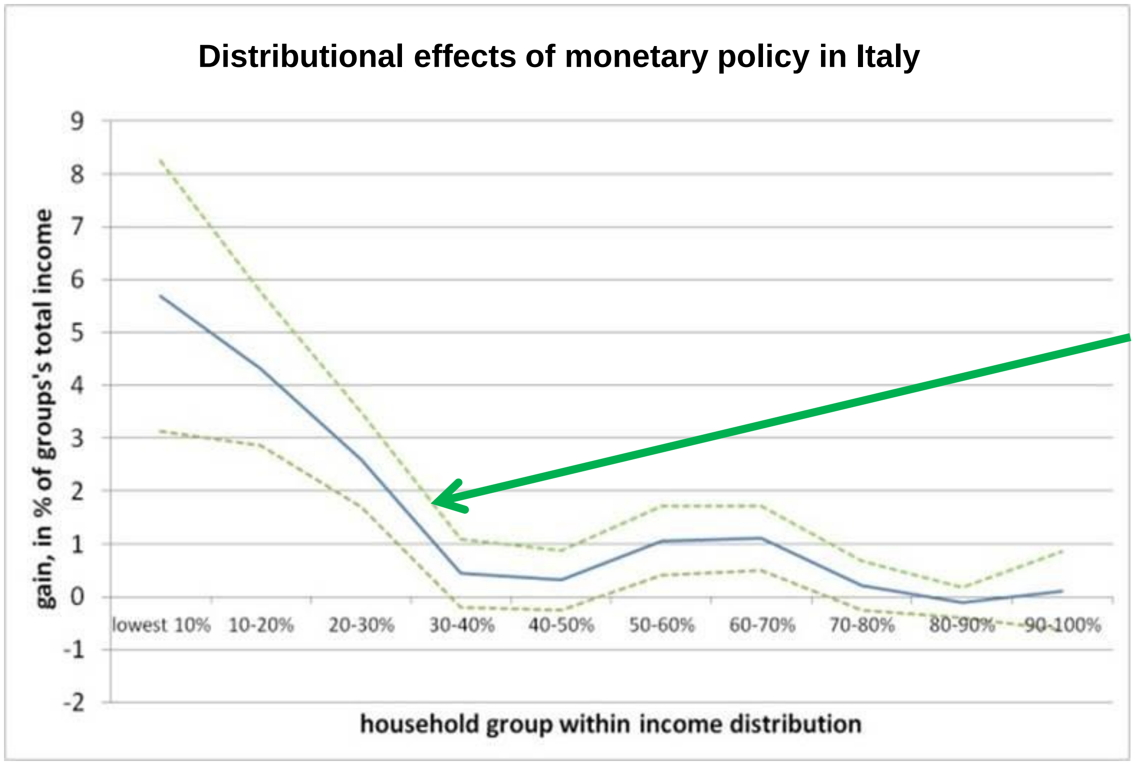

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1. The rich benefited from <u>financial gains.</u>
2. The poor benefited from <u>cheaper debt</u> and higher <u>labor income</u>.

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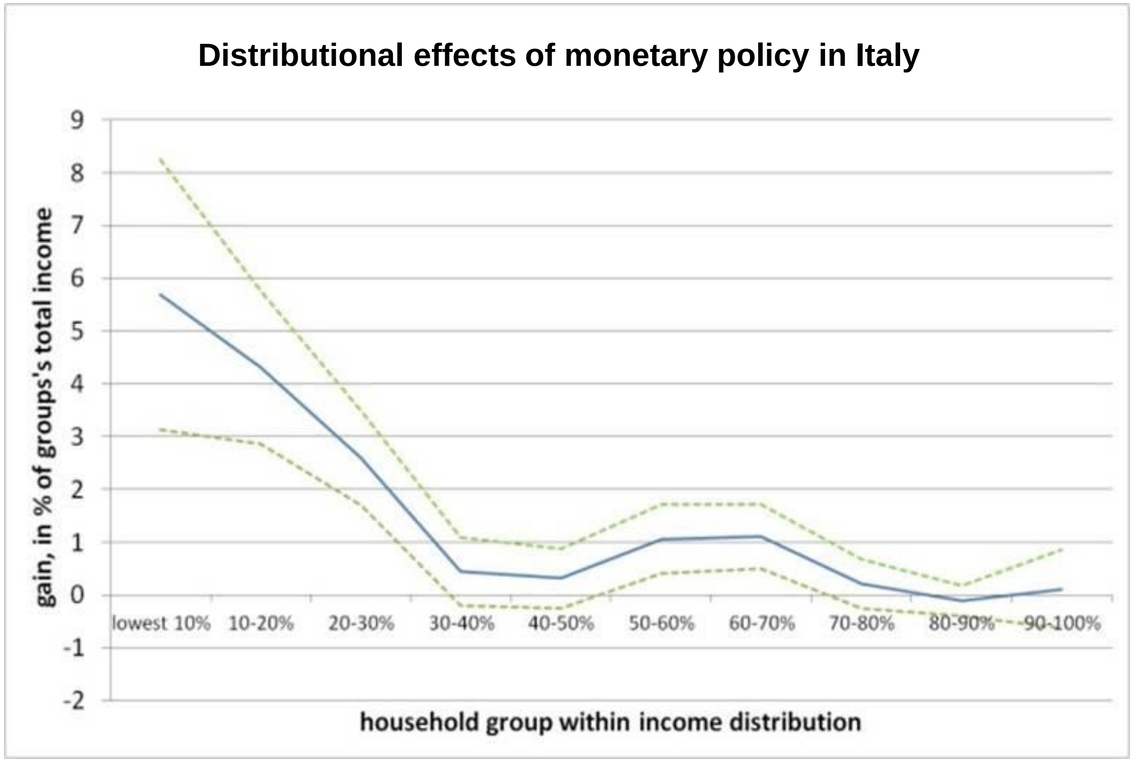

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1. The rich benefited from financial gains.

2. The poor benefited from cheaper debt and higher labor income.

3. **Inequality decreased.**

Conclusions

- Central banks have been tested severely.
- The conventional wisdom we inherited from the Great Moderation era is also (rightly) under examination:

"The state of macro is good"	(Blanchard, 2008)
"How could we get it so wrong?"	(Krugman, 2008)

- Both the policy and the academic challenge are far from over.
- But some tentative lessons can be drawn as of today.

Conclusions

What did we learn?

i. Stick to price stability.

ii. Monetary policy works, but it should not be left alone.

iii. Risk taking and inequality are important in principle but (as of today) negligible in practice.

iv. Never say never.

Thank you