Monetary Policy Approaches: A Comparative Appraisal

Report on a conference jointly organised by Bank of Finland and SUERF
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Conference Report

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In the wake of monetary policy strategy reviews announced by the ECB in July 2021 and the Fed in August 2020, this online conference gathered leading experts from both policy and research side to discuss different monetary policy approaches. The challenges that policy makers have faced, and which have partly spurred the strategy review work relate among other things to the low interest rate environment, slow productivity growth and dealing with large macroeconomic and financial shocks but also to issues such as the climate change and inequality. Many of the presentations touched upon these themes, including both original research papers as well as more policy-oriented presentations. The presentations were organized in two sessions, the first under the heading "(Un)conventional approaches" and the second on "Central banks in a changing world". During the lunch break, two research papers were presented as virtual poster presentations. The concluding panel, chaired by Bank of Finland Board member Tuomas Välimäki, and featuring Philip Lane, Andy Levin and Patricia Mosser focused on the experiences of and views on the recent strategy reviews. In the following we provide a short summary of each presentation including some highlights also from their Q&A parts and the panel discussion.

The event started with an **opening address** by the **Bank of Finland Governor**, **Olli Rehn**. Governor Rehn spoke about the economic recovery in the euro area, and the ECB's recently concluded strategy review. His remarks mainly concerned the most important revision to the ECB's monetary policy framework: the symmetric 2% inflation target over the medium-term. "Symmetry" unambiguously implies that both faster and slower inflation are equally undesirable. Commitment to a symmetric inflation target requires strong, long-term monetary policy measures when interest rates are near the effective lower bound.

Governor Rehn also spoke about interactions between monetary and fiscal policy in the euro area. He emphasized that in times of crisis, when interest rates are low, counter-cyclical fiscal measures complement monetary policy. Furthermore, low interest rates create favourable financing conditions that help fiscal authorities pursue complementary, stabilizing policies. At the same time, high levels of debt raise the spectre of fiscal dominance and debt crises, and ultimately a strong fiscal framework is essential for the monetary union.

Session I: (Un)conventional approaches

The first session opened with a presentation by prof. **Klaus Adam** (University of Mannheim, CEPR, CESIfo) on **"Central banks' objectives, targets, and tools"**. He started off by noting a surprising feature of the new ECB strategy, namely that the number of secondary objectives (eg new focus on climate change) seems to have increased. This is surprising from two perspectives: (i) the review has been preceded by an episode where the primary objective – price stability – has not been perfectly met, and (ii) there appears to be no added new tools to address these additional objectives. Moreover, there is no analysis for how the secondary objectives interact with the primary objective, which is a practical concern for policymaking and will have to be addressed in future strategy reviews.

However, Klaus praised the clarity of the updated definition of the price stability objective in the new strategy. But he also noted that there was little in terms of analysis to motivate the precise number of 2%. Luckily for us, Klaus has the answer based on an ingenious model that incorporates declining relative prices over products lifecycles. The idea is simple: a price distortion is created if firms face adjustment costs as they want to lower prices over a product's lifecycle. By generating inflation equal to the inverse of the efficient relative price trend, monetary policy can minimize the distortion as producers no longer have to change the prices of older models (they simply let inflation lower their value over time). Based on this mechanism, empirical estimates and a sticky price model suggest that the optimal level on inflation in the Euro Area (EA) is – lo and behold – below but close to 2% (Klaus gives the number 1.5%). But add concerns over the efficient lower bound (ELB) and the actual number is probably somewhat higher. Unfortunately, Klaus's model didn't have an ELB in it, so the optimal target would remain somewhat unmotivated, albeit less so than before.

There were several questions from the audience including one on the effect of different degrees of price stickiness in different sectors. According to Klaus, this important concern turns out to be not of first order importance.

The **second presentation**, **"Monetary policy and financial stability"**, was given by **Oreste Tristani** (ECB). He posed two questions based on an ECB occasional paper in his talk. What is the economic case for monetary policy (MP) to consider financial stability concerns? What are the practical implications for the ECB? While noting that macroprudential policies are the first line of defense against buildups in the financial cycle, the presence of spillovers to monetary policy and vice versa would make the case for some degree of coordination. The ECB paper finds that such spillovers are pervasive (eg common transmission mechanisms such as the effect of monetary policy on banks profitability). Hence, monetary policy should factor in some financial stability concerns (and the other way around).

On the practical implications, Oreste argued for a symmetric approach involving both leaning (which is controversial) and cleaning (which is less controversial). The compromise solution is (i) an "enhanced" role for financial stability concerns in monetary policy, (ii) regular presentations on topics concerning financial stability at MP meetings, and (iii) further development of prudential tools.

Among the questions from the audience was one on the right sequencing of policy to offset risks with increased lending during the Covid-19 crisis.

The third paper, **"Indebted demand and implications for monetary policy"**, was presented by **Ludwig Straub**, Professor at Harvard University. Ludwig presented a stylized model with rich savers (high endowments; low marginal propensities to consume) and poor consumers (vice versa), where higher debt levels – due eg rising inequality – drive down the real equilibrium interest rate. This is the opposite direction of causation to the one conventionally assumed, where lower rates lead to higher indebtedness. The key channel in Ludwig's and his co-authors' paper is flows of funds between the borrower and the lender: initially there is a boom when funds (new borrowing) flow to borrowers with high marginal propensity of consumption (MPC), but this is followed by a contraction when the flows reverse (debt service). If indebtedness becomes high enough, it can push real rates below the ELB and cause a debt trap.

The true policy implication is to address rising income and wealth inequality. But as the session chair **Juha Kilponen** pointed out, this requires a consorted effort globally, which seems rather unlikely. Ludwig then suggested that momentum for such efforts could emerge if Europe and the US would lead the way (which at the time of writing may seem even more unlikely). Klaus Adam asked if we shouldn't see a massive investment boom with declining real interest rates in contrast to the behavior in actual data. Ludwig replied that this is indeed an excellent point, but one that applies to virtually all models of declining r*, and he called for more research to better understand this relationship. (It often seems acceptable in economics to simply ignore this gap between models and reality and carry on as if we understand declining real interest rates.)

Lunch/virtual poster session:
Analyzing communication to infer policy-makers intentions and preferences

In the **first virtual poster paper**, **"Who talks during monetary policy quiet periods, and why? Evidence from the European Central Bank's Governing Council"** by **Phillipp Gnan** and **Kilian Rieder** who also presented, the authors provide the first systematic analysis of individual monetary policy-makers' incentives to communicate during quiet periods in the run-up to policy meetings. Drawing on ECB proprietary sources, they construct a novel statement-level data set documenting the evolution of quiet period communication by ECB Governing Council members between 2008 and 2020. They find that members' policy-making experience and expertise are robustly associated with breaches of quiet period rules. Exploiting plausibly exogenous variation in the ECB rotational voting schedule, the authors show that non-voting members do not engage in strategic communication during the quiet period to lock in their voting peers. Finally, the paper reviews the ECB-internal classification of statements into breaches and non-breaches. The authors argue that this classification is prone to loopholes and appears to under-report non-compliance by ECB Executive Board members before 2014.

The second paper, **"Reading between the lines – using text analysis to estimate the loss function of the ECB"** was based on the recent study by **Maritta Paloviita**, **Markus Haavio**, **Pirkka Jalasjoki**, **Juha Kilponen** and **Ilona Vänni** and was presented by Markus Haavio. The paper applies text analysis to extract the tone (sentiment) from the introductory statements to the ECB's press conferences. By combining this information with Eurosystem/ECB staff macroeconomic projections, the authors directly estimate the Governing Council's loss function. The results suggest that prior to the new monetary policy strategy, announced in July 2021, the de facto inflation aim of the ECB was considerably below 2%. The analysis also indicates that the ECB's loss function may have been asymmetric, meaning that the ECB has been more averse to inflation above 2% than below 2%. The ECB's new definition of price stability implies a symmetric loss function with a bliss point at 2.0%. Hence the results of the study indicate that the new strategy will bring about a clear change in the Governing Council's policy preferences.

Session II: Central banks in a changing world

The second session was mainly a policy-oriented overview session discussing three of the main topics in current monetary policy making, with presentations covering, respectively, climate change, inequality, and fiscal-monetary interactions. Specifically, it **consisted of the following presentations**: **"Central banks and climate change"** by **Anna Breman** (Deputy Governor, Sveriges Riksbank), **"Monetary policy and inequality"** by **Fiorella de Fiore** (Head of Monetary Policy, BIS) and **"Policy interactions between monetary and fiscal policies"** by **Leonardo Melosi** (Federal Reserve Bank of Chicago).

The first presentation (**Breman**) started by **stressing the importance of climate change for monetary policy** due to the impact of the former on prices (incl. asset prices), risk and financial stability. Then, it highlighted three ways in which the Riksbank approaches the climate change challenge: through research, regulation, and readjustment of its balance sheet.

Research focuses on assessing the economic transition to warmer climate, such as changes in consumption patterns and carbon taxation, as well as on physical risks (extreme weather, melting icecaps etc.) and their consequences for the cost of energy, inflation and its expectations, output and, ultimately, monetary policy.

On the regulation side, the Riksbank sees the need for more micro data on emissions and emission disclosure policies based on international standards. For that reason, more international and inter-institutional cooperation is needed. Emissions disclosure is much lower among private-owned firms as compared to publicly traded ones.

Regarding its balance sheet, the bank rebalances its portfolio by selling debt with high carbon trace. For example, it reduced the debt of high-trace provinces in Canada and Australia in favor of low emitting ones. It also decided to apply negative screening criteria for corporate bond purchases in quantitative easing (QE) operations.

In the **Q&A** part, the idea of an industrial emissions database was suggested. Could central banks and the BIS work on developing a database widely accessible by the private sector for use in, e.g. sustainability reports and in credit quality analysis by banks. Breman replied that good data exists in some sectors (e.g. steel) but not in others. She stressed the need of mandatory disclosure and global standards (IFRS and IOSCO work on this).

The second talk (**De Fiore**) started with presenting **broad evidence that inequality** (of wealth and income) **has been on the rise since the turn of the 1980s**. It stressed that monetary policy affects inequality implicitly through the business cycle (e.g. hysteresis), inflation (which hits the poor most). In advanced economies monetary tightening slightly increases inequality whereas in emerging markets it reduces inequality substantially.

Causality goes also in the other direction as inequality affects the transmission mechanism and its effectiveness. When inequality is high, borrowing constraints are tighter on average. This makes people less reactive to policy rates. As a result, recessions are deeper and the response of consumption to interest rates weaker.

Fiscal policy may reduce inequality, especially through progressive taxation. Monetary policy has few or no tools to tackle inequality. However, monetary policy can have some impact within its mandate.

In the **Q&A** it was stressed that both recessions and high inflation hit especially the poor, so any MP mistakes are especially harmful for them. Is there therefore a tradeoff between boosting the economy and restraining inflation in terms of impact on the poor? According to De Fiore the tradeoff exists but is limited in advanced economies. However, prolonged expansions may boost income of the poor while inflating wealth of the rich, with ambiguous net effect on inequality. Another question was whether inequality can guide the choice of MP tools? Answer: different tools do have different inequality effects but inequality per se should be the concern of fiscal policy, not MP whose mandate, role and impact in this regard is very limited. Breman added that indeed, considerable inequality-related tools were undertaken by the Swedish government whereas the Riksbank tried to support the economy, i.e., all firms and households.

The last presentation (**Melosi**) discussed **stabilization policy tools in the euro area**. MP has little policy space with very low rates and binding ELB. It is hard to generate inflation given that, e.g., the effectiveness of forward guidance is highly limited due to commitment and credibility issues. MP is also constrained by the heterogeneity of debt in its member states. Fiscal policies must adhere to strict fiscal rules which leaves no available stabilization tools, especially for highly indebted EU counties. Slow growth spills over across all member states. Political polarization across the EU constrains a common budget and inter-state transfers.

Melosi proposes a solution to solve the stabilization tools scarcity problem by issuing Eurobonds. In the proposal, low-debt countries would not be held responsible for others' debts. The bonds would have no indication on the fiscal tools needed to repay them (nor a time horizon). This repayment ambiguity would convince the market that this debt would be (at least partly) inflated away and therefore give credibility to forward guidance measures. Hence the (desired) inflation would follow. It is the role of MP to determine what fraction of Eurobonds is to be inflated away and what is the tolerable level of inflation overshooting consistent with its target and objectives. The policy is combined with strict fiscal discipline at national level. The proposal is rationalized in a model by Bianchi, Melosi and Rogantini Picco (2021), which is work in progress.

In the **Q&A** session it was stressed by Melosi that such inflationary measures can be used recurrently depending on the severity of the recession and could be regarded as a form of automatic stabilizer. He stressed that no new fiscal institution is needed (which would be politically hard to do) to determine the new budget. There would be no automatic monetization of debts but instead, the ECB would decide how much to inflate away in line with its desired inflation target (hence central bank independence would not be abandoned).

The common Q&A round discussed the problem of central bank "Mission Creep" problem of too many new (e.g. inequality, climate) policy objectives and whether independence is still a virtue worth and possible to sustain. All speakers agreed that the mandate is clear, and independence is crucial to be able to implement the mandate, although coordination with fiscal policy is desirable.

Panel Discussion: Experiences from central banks' strategy reviews

The online conference ended with a **panel discussion chaired by Tuomas Välimäki** (Bank of Finland Board Member). He started with a discussion on the ECB's strategy review. The previous inflation objective was vague, and the ECB was seemingly missing its target. He also argued that a credible strategy is important for the anchoring of inflation expectations.

Here is a summary of some of the points made by the discussants.

Philip Lane (ECB Executive Board Member) finds the idea of regular strategy reviews as started by Bank of Canada good. He discussed the new strategy with a more explicit symmetric 2 per cent target. He stressed the importance of forward guidance, highlighting that 2 per cent is a medium-term target. Lane also discussed the recent increases in inflation. He argued that current increases in inflation are likely temporary and do not necessitate a rate hike. He also pointed out that core inflation, that excludes energy prices, has increased only moderately. Finally, he mentioned that financial markets have not fully absorbed the forward guidance by the ECB.

Andrew Levin (Dartmouth College) explained that CBs do not have full autonomy. Hence part of the reason for a strategy review is to engage with stakeholders. The Fed chose to mitigate the effects of the ELB with and average inflation target (AIT). Levin brought up a potential problem with the strategy: average inflation might soon require a rate hike according to their target, but raising rates is politically problematic in the current environment. In addition, high US public debt is a potential worry, especially if a new shock leads to additional fiscal spending.

He also mentioned that maximum employment is still a vague target. Finally, he argued that central banks should think more in scenarios and communicate policies conditionally on many paths.

Patricia Mosser (Columbia University) is sympathetic to AIT, but also finds the current environment challenging; COVID is a tail event complicated by supply shocks and large fiscal stimulus. She also pointed out a good side of the AIT: it forces the Fed to look more at the labor market.

She compared the economic situation between US and other currency areas: US is insulated from many smaller supply side shocks because commodities are priced in dollars.

She sees lack of monetary policy space a problem especially in case of additional negative shocks. She also finds it interesting to see how central banks tolerate being above their inflation targets. She mentioned that there is still uncertainty about the Fed's reaction function and that it is not clear what policy will be in 2023 or 2024.

She argued that central bank communication is probably too complicated for many people. Central banks should also not avoid talking about fiscal policy, countercyclical fiscal policy is playing a key role in the current environment. She replied to Levin's worries about high debt: she finds fiscal contraction more likely at least in the short run as governments will tune down COVID related stimulus.

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